



International Monetary Fund

July 2024

A stylized world map in a light green color, showing the continents and major landmasses.

The Last Mile: Financial Vulnerabilities and Risks

Fabio Natalucci

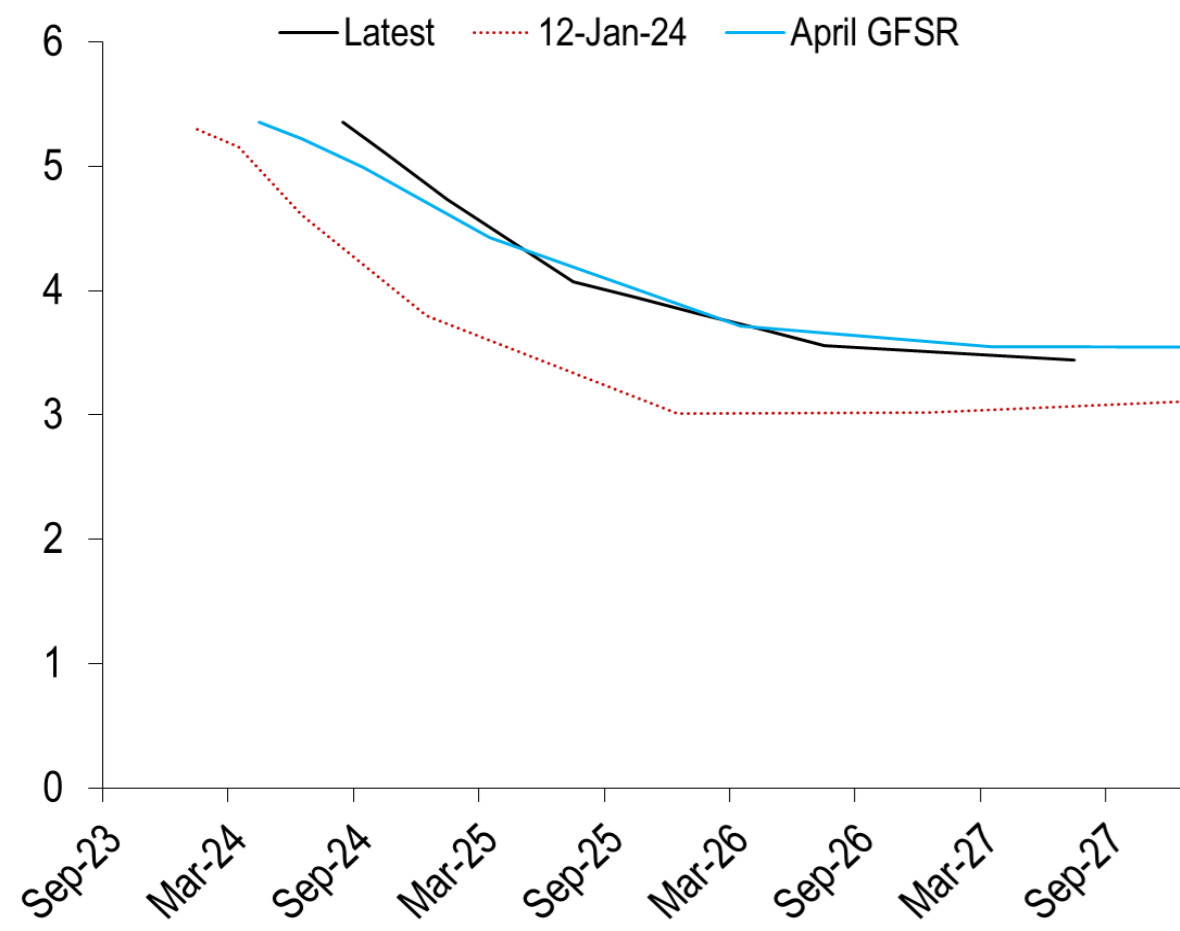
Deputy Director

Monetary and Capital Markets Department

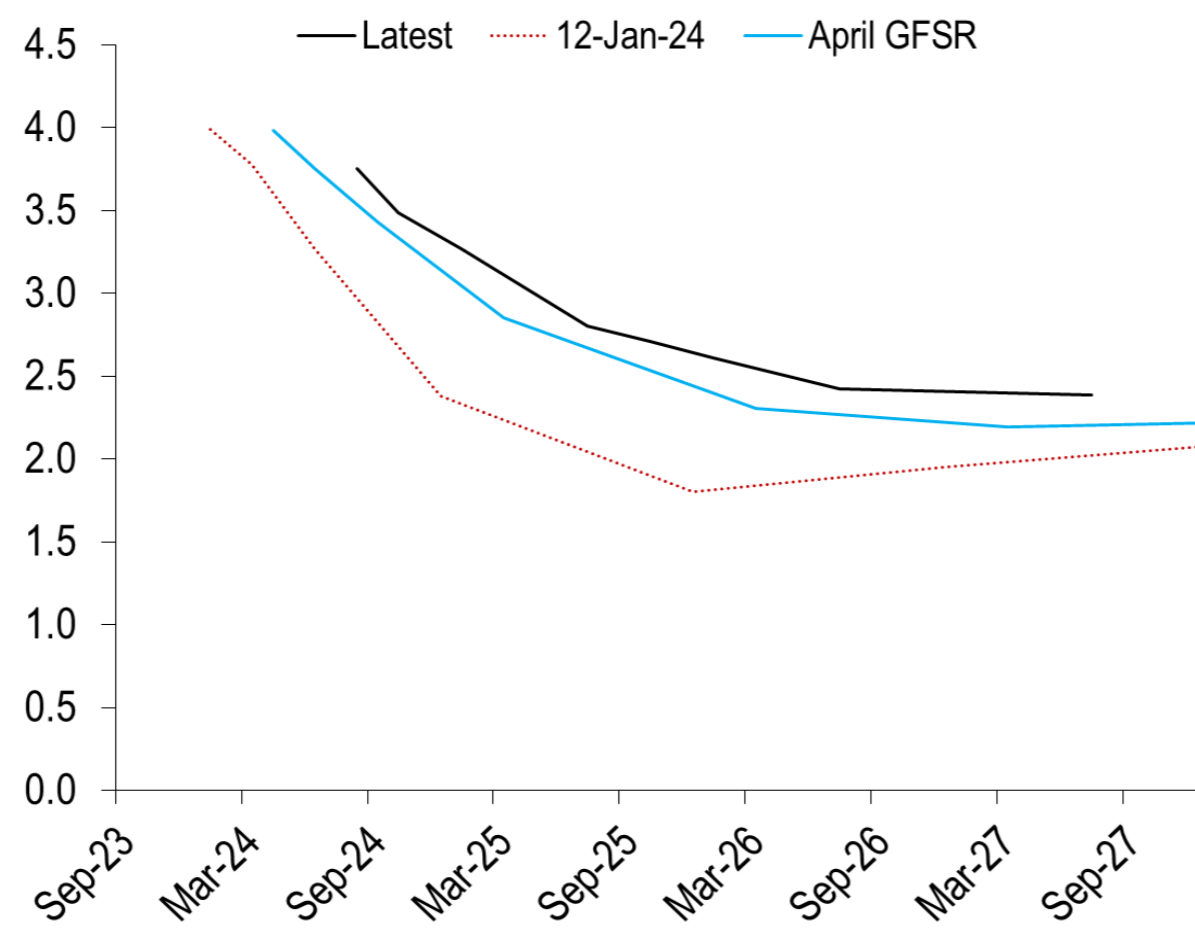
Markets Expect Most Major Banks to Cut Policy Rates this Year

Greater confidence of soft-landing

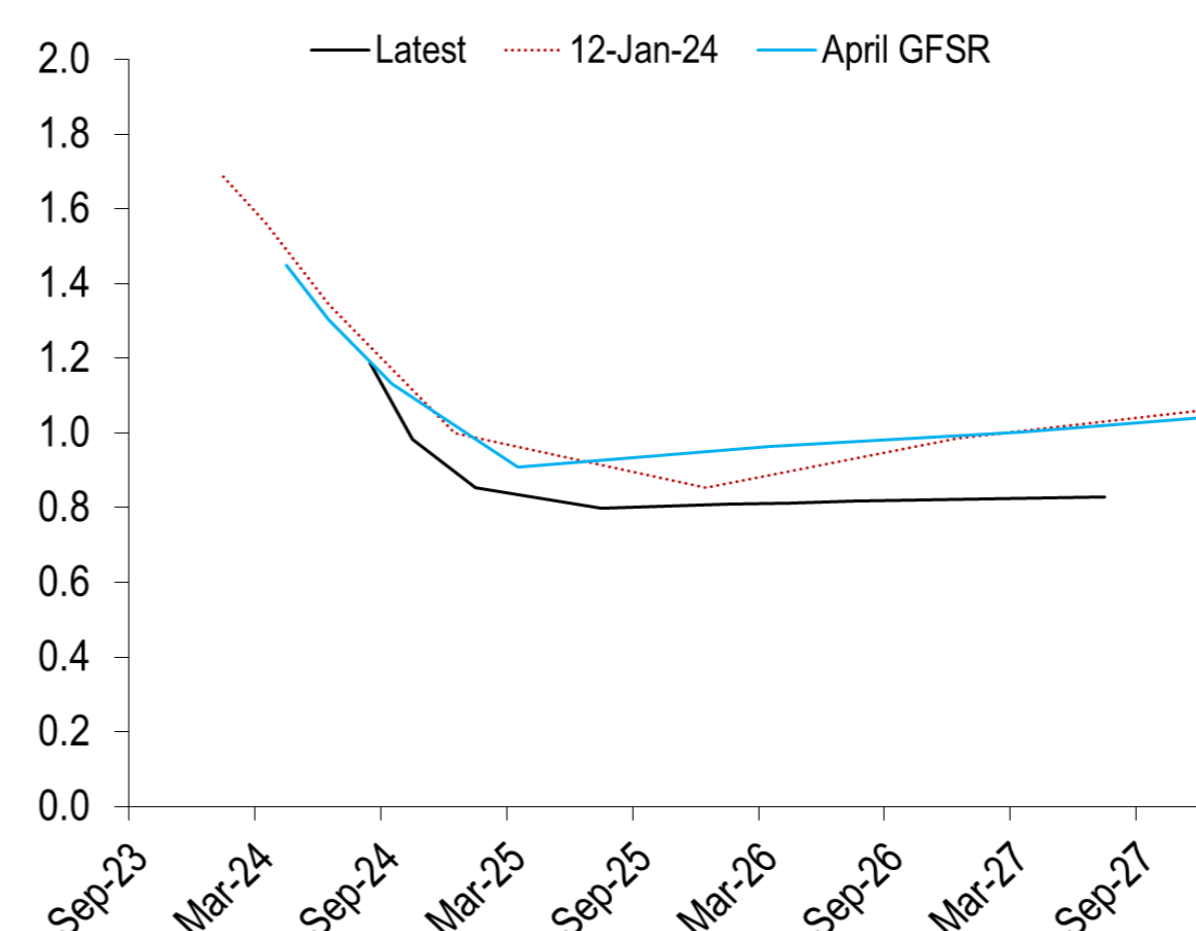
1. United States (Percent)



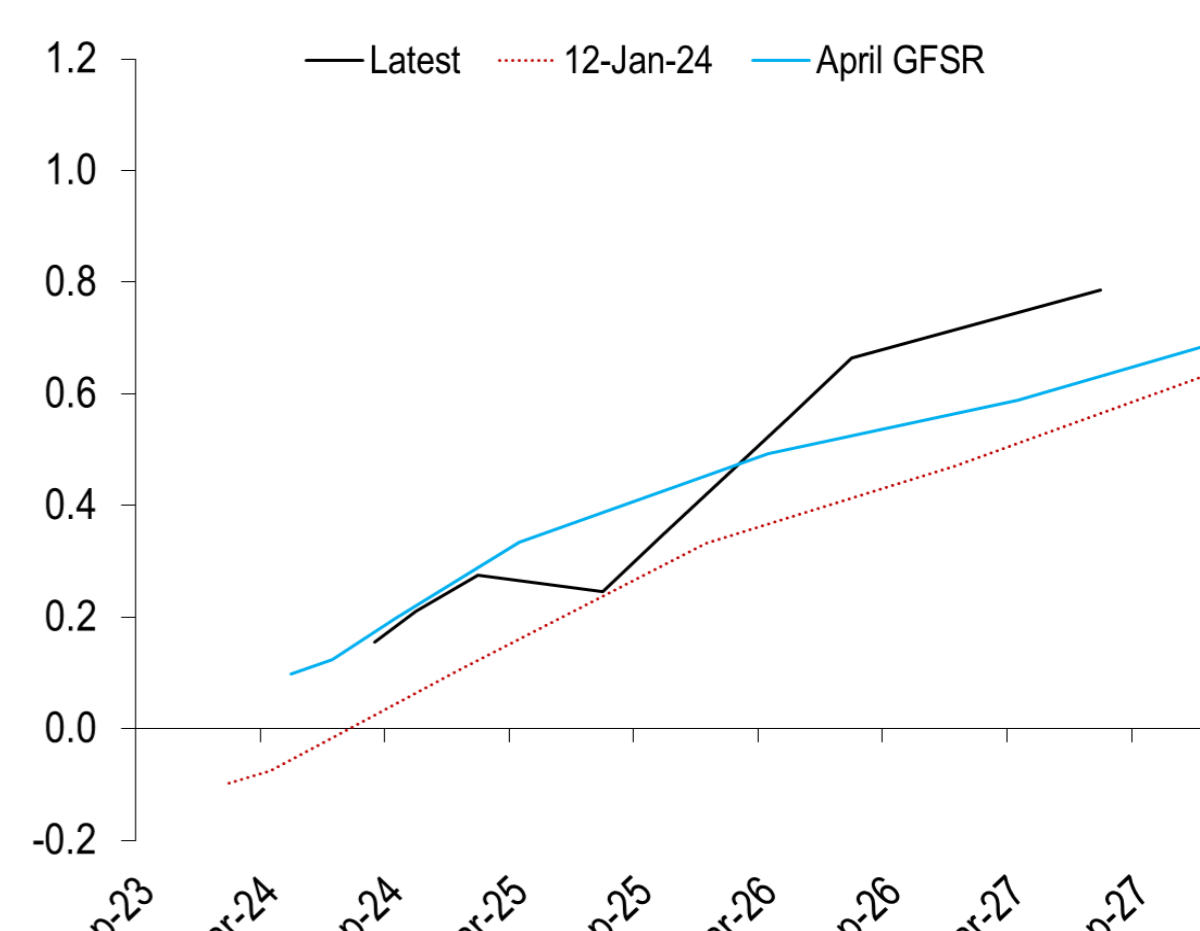
2. Euro Area (Percent)



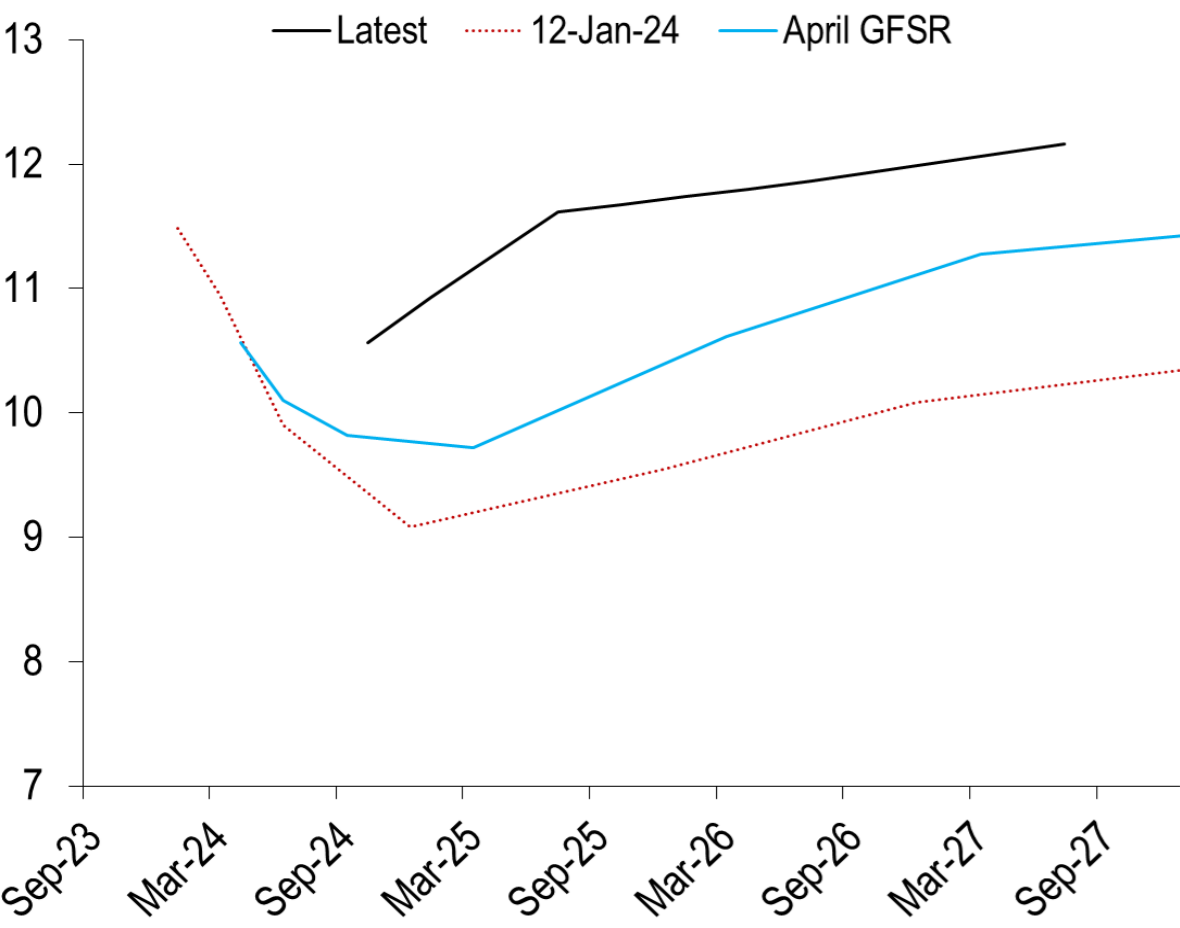
3. Switzerland (Percent)



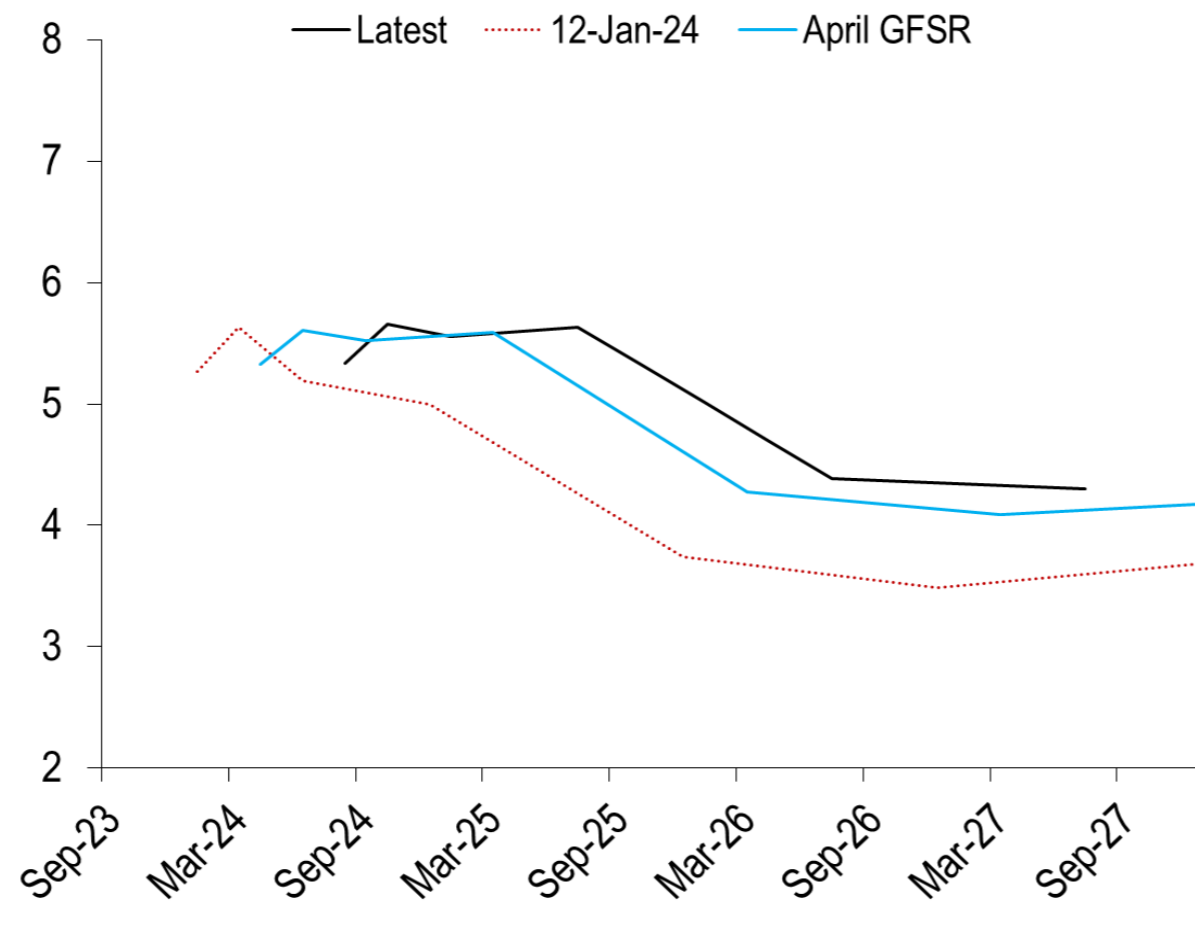
4. Japan (Percent)



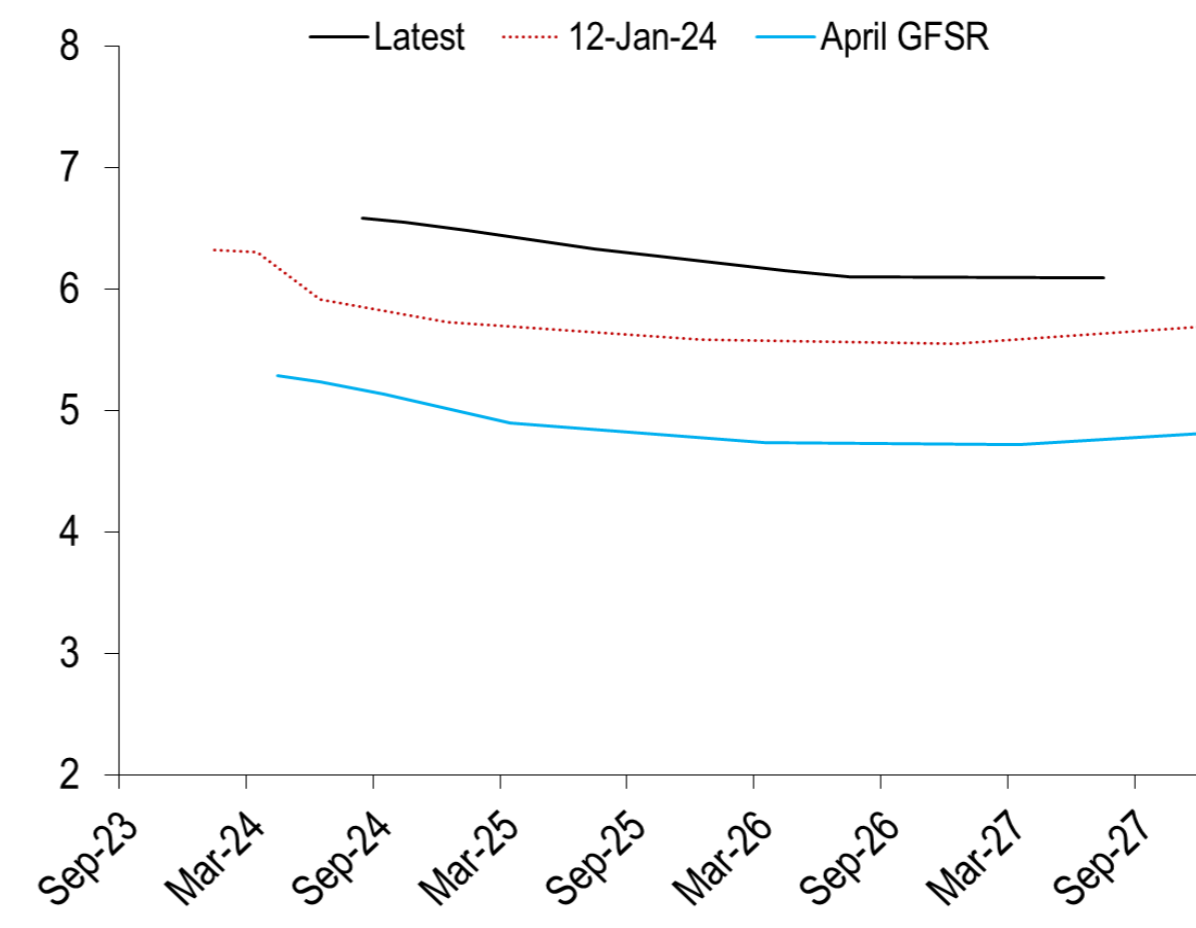
5. Brazil (Percent)



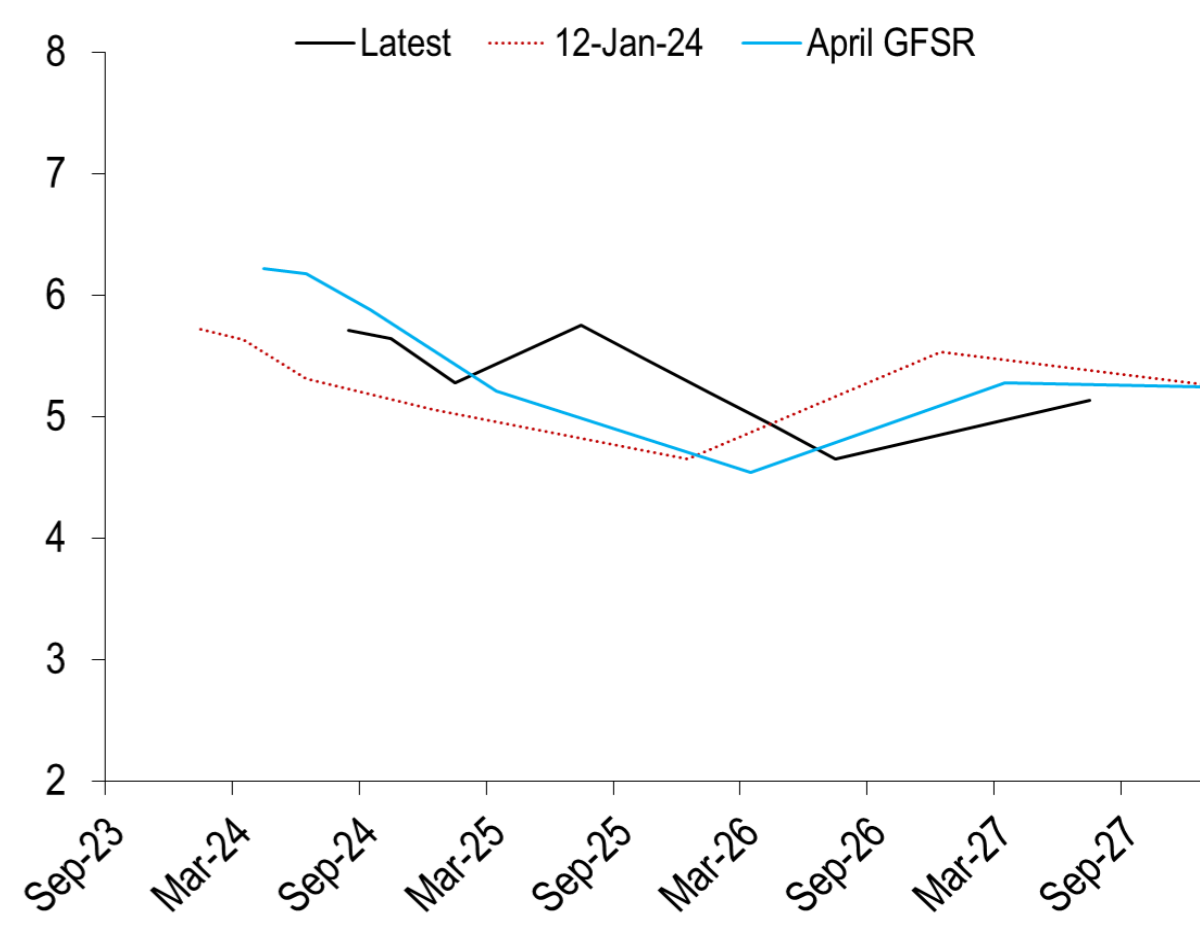
6. Poland (Percent)



7. India (Percent)



8. Philippines (Percent)

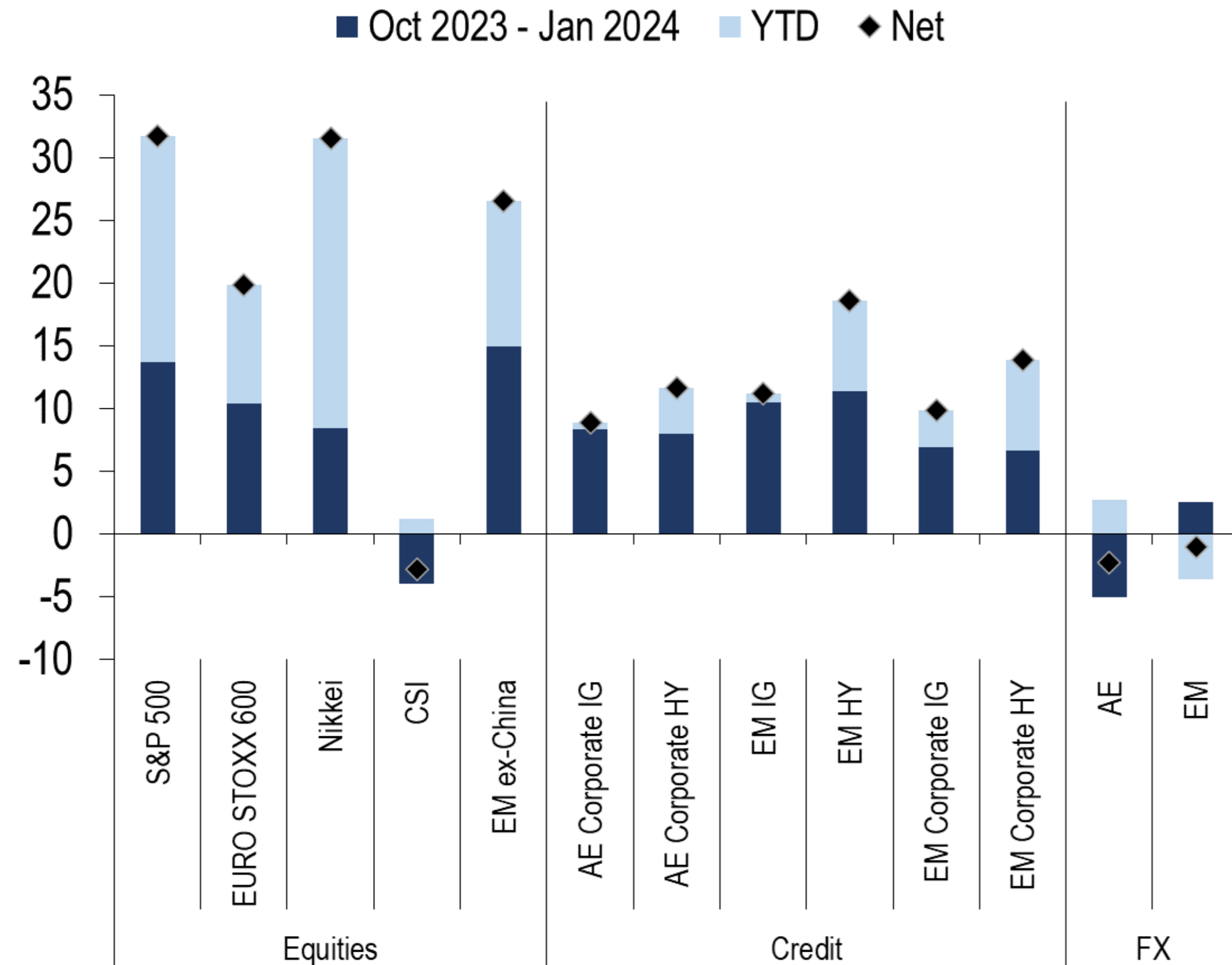


Supporting Broad-based Rally in Risk Assets

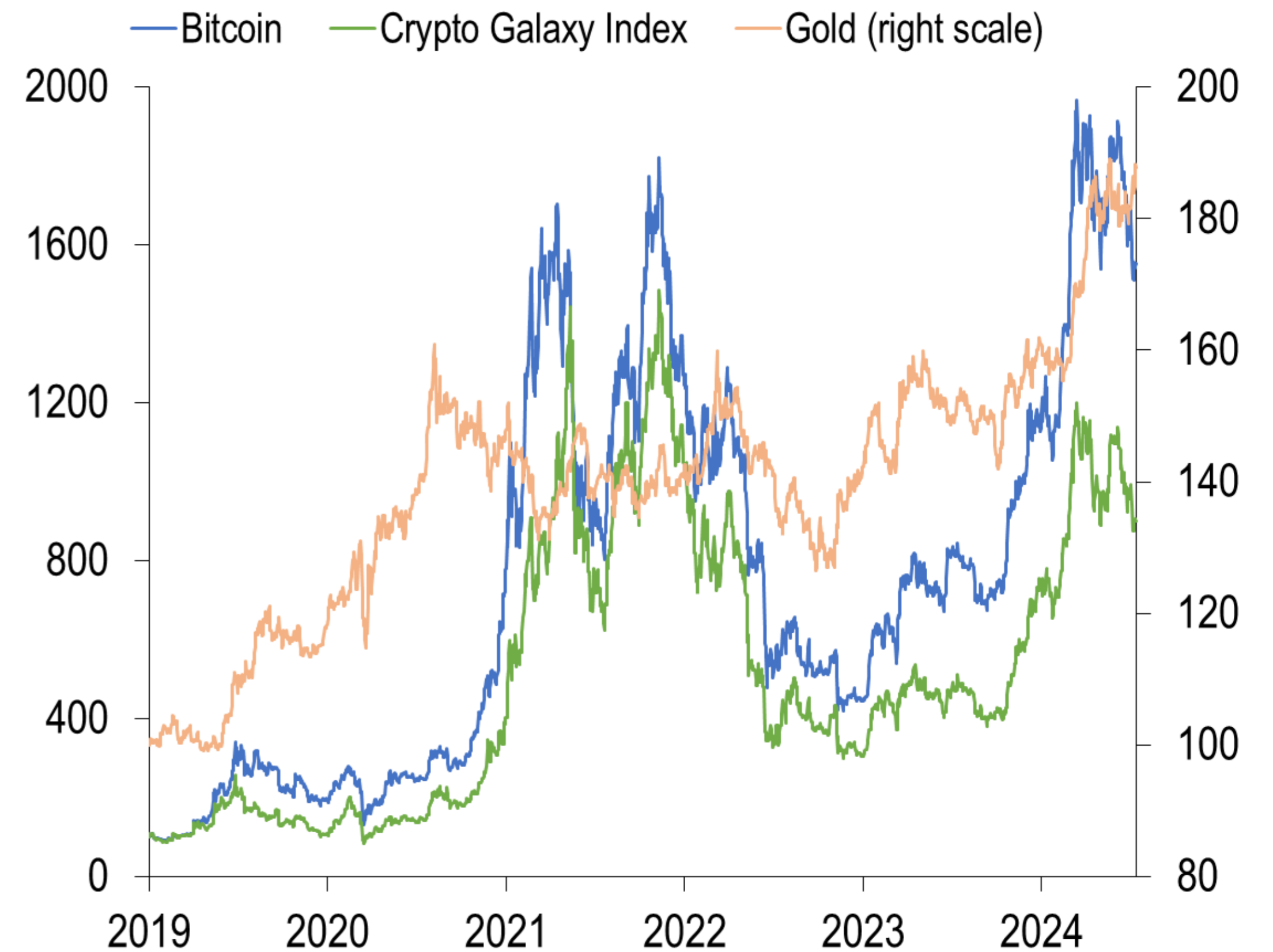
Broad-based rally in traditional global risk assets

Alternative asset classes also experienced gains, helped in part by sector-specific tailwinds

Cross-asset Performance
(Percent; based on total return indices)



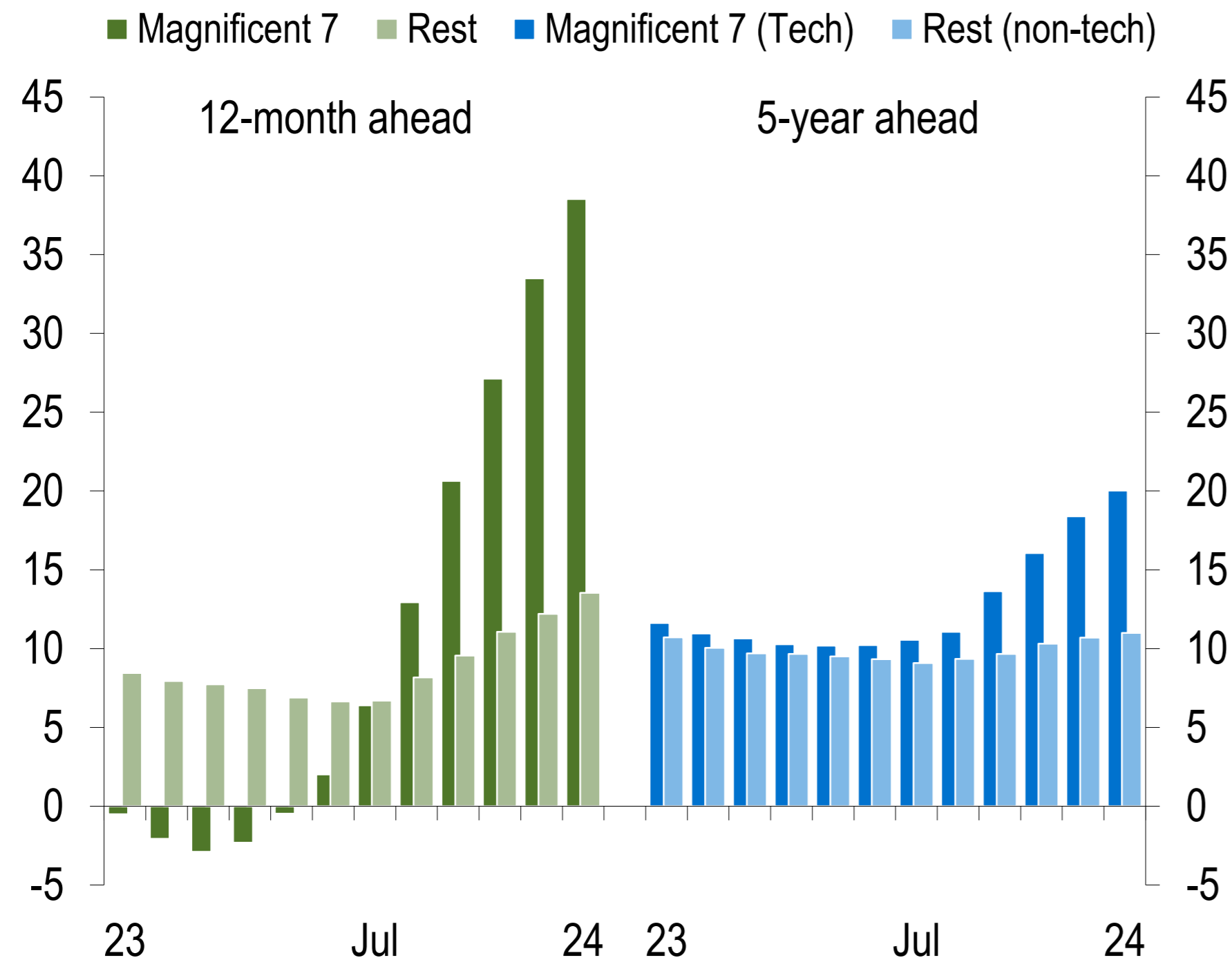
Bitcoin and Gold Prices
(Index, Jan 2019 = 100)



Equities Propelled by AI Optimism Amid Rising Concentration

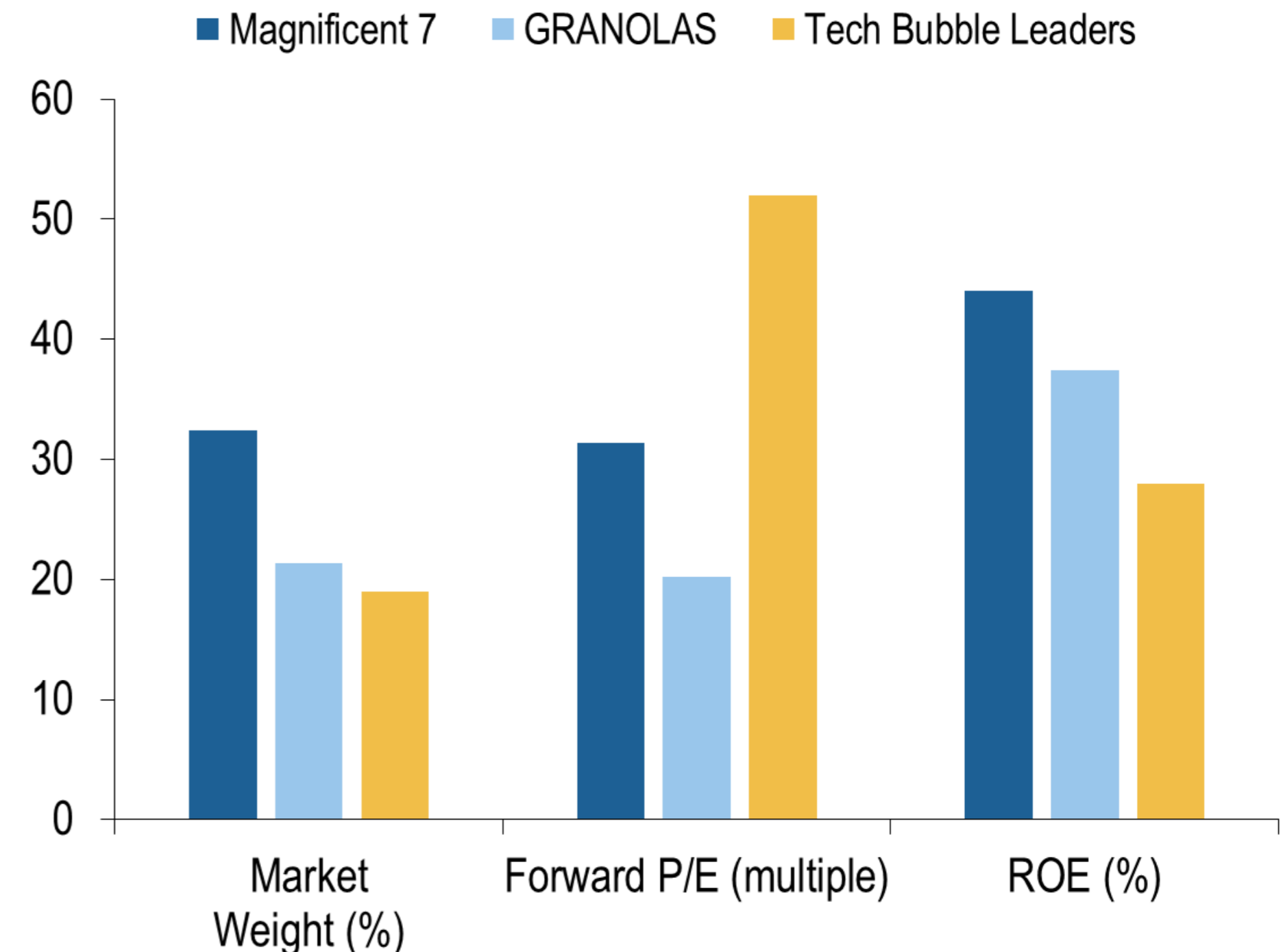
Optimism of AI-driven productivity growth led to significant increase in earnings growth expectations

Earnings Per Share Growth Expectations (Percent)



Unlike the tech bubble, market concentration appears to be backed by solid fundamentals and less extreme valuations

Current Leaders versus 2000s Tech Bubble (Percent; multiple)



Market concentration: Defined as the weight of market capitalization of stocks within broad equity index, in each jurisdiction

Magnificent 7: Microsoft, Apple, NVIDIA, Amazon, Alphabet, Meta, Tesla. **GRANOLAS:** GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP and Sanofi.

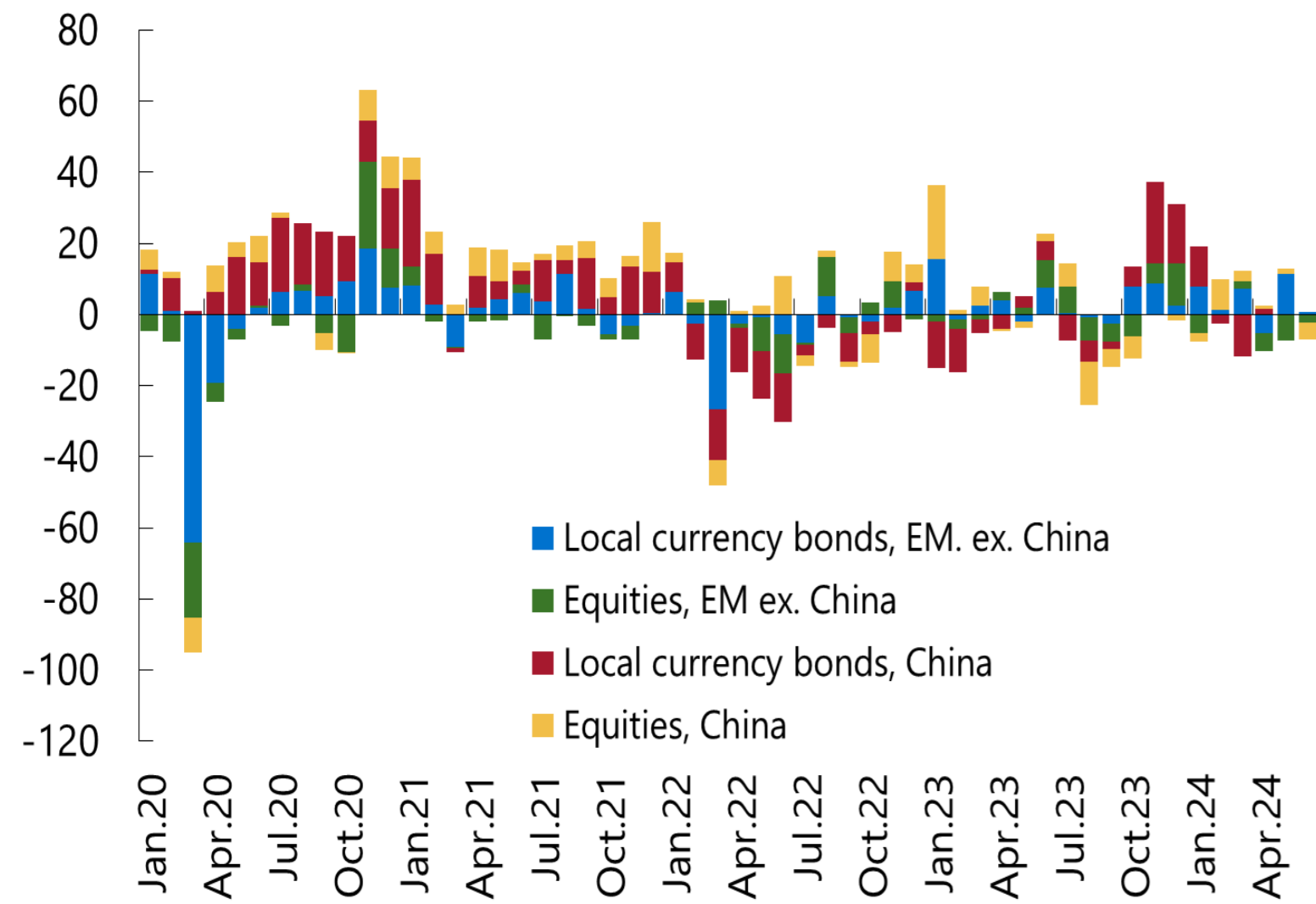
Tech bubble leaders: Microsoft, Cisco, Intel, Oracle, IBM, Lucent, Nortel.

Sentiment on Major EMs Has Improved

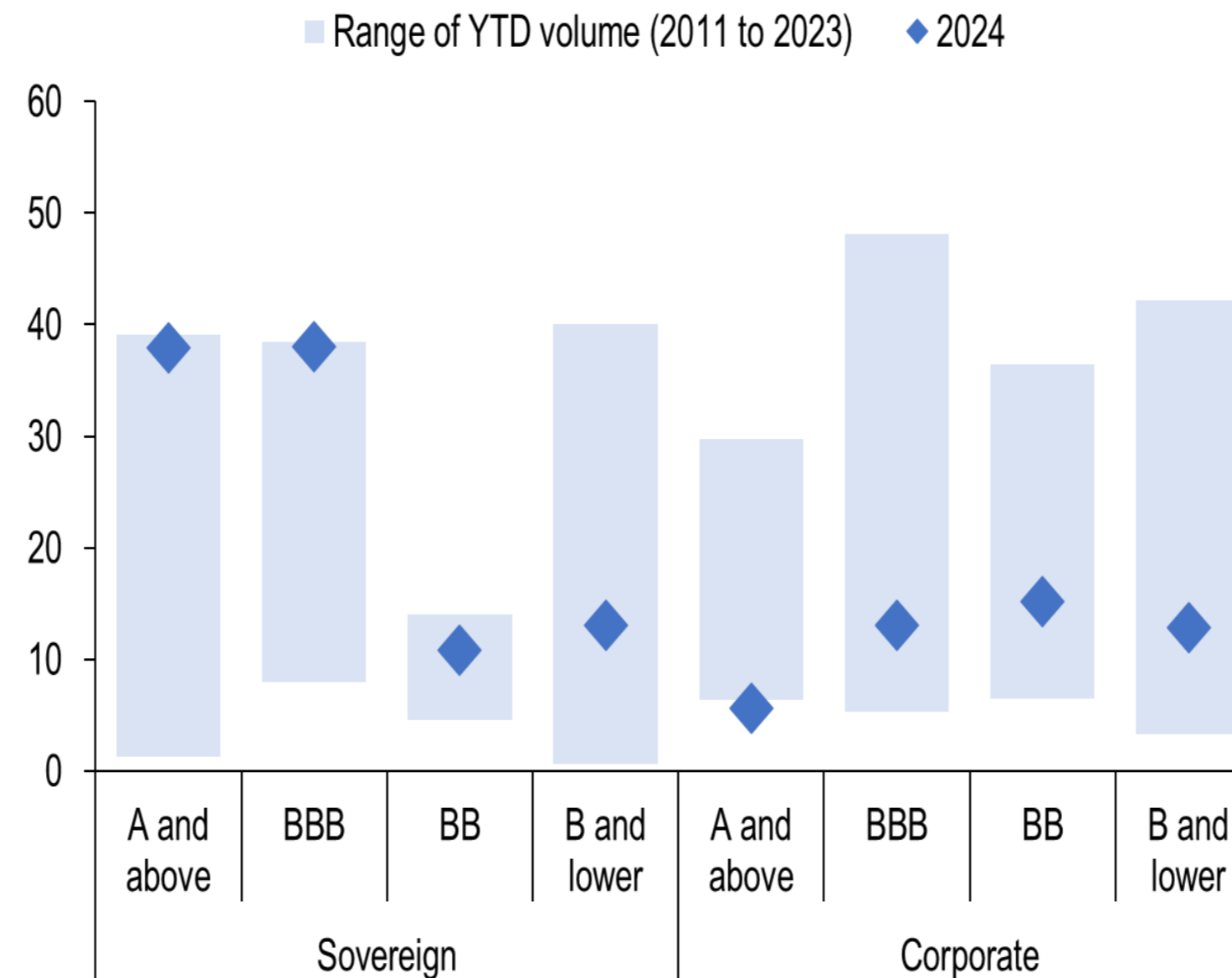
Positive market sentiment has helped rekindle portfolio flows...

...and supported strong sovereign issuance.

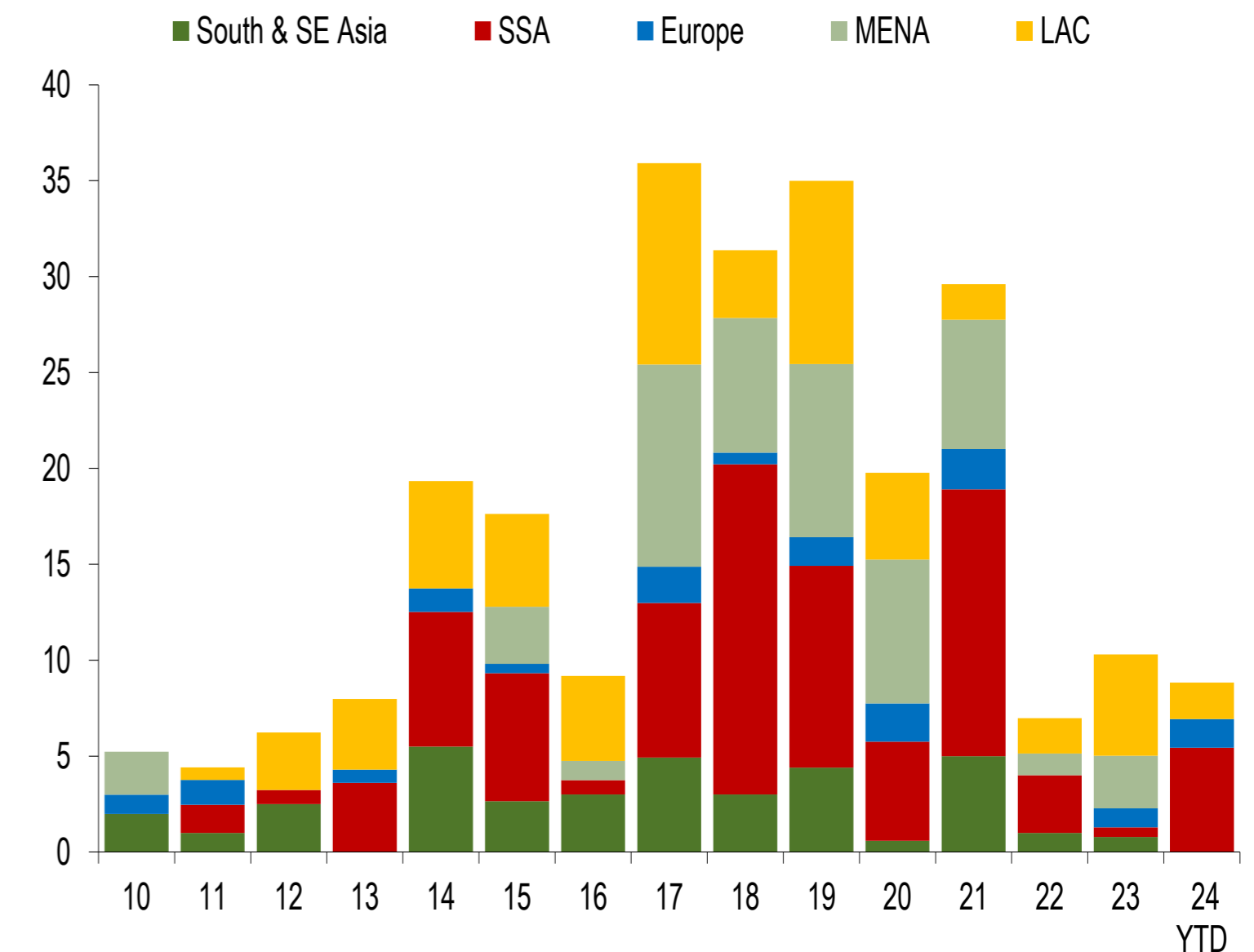
Emerging Markets Portfolio Flows (USD, billions)



Emerging Markets Hard Currency Issuance (USD, billions)



Frontier Sovereign Issuance by Region (USD, billions)

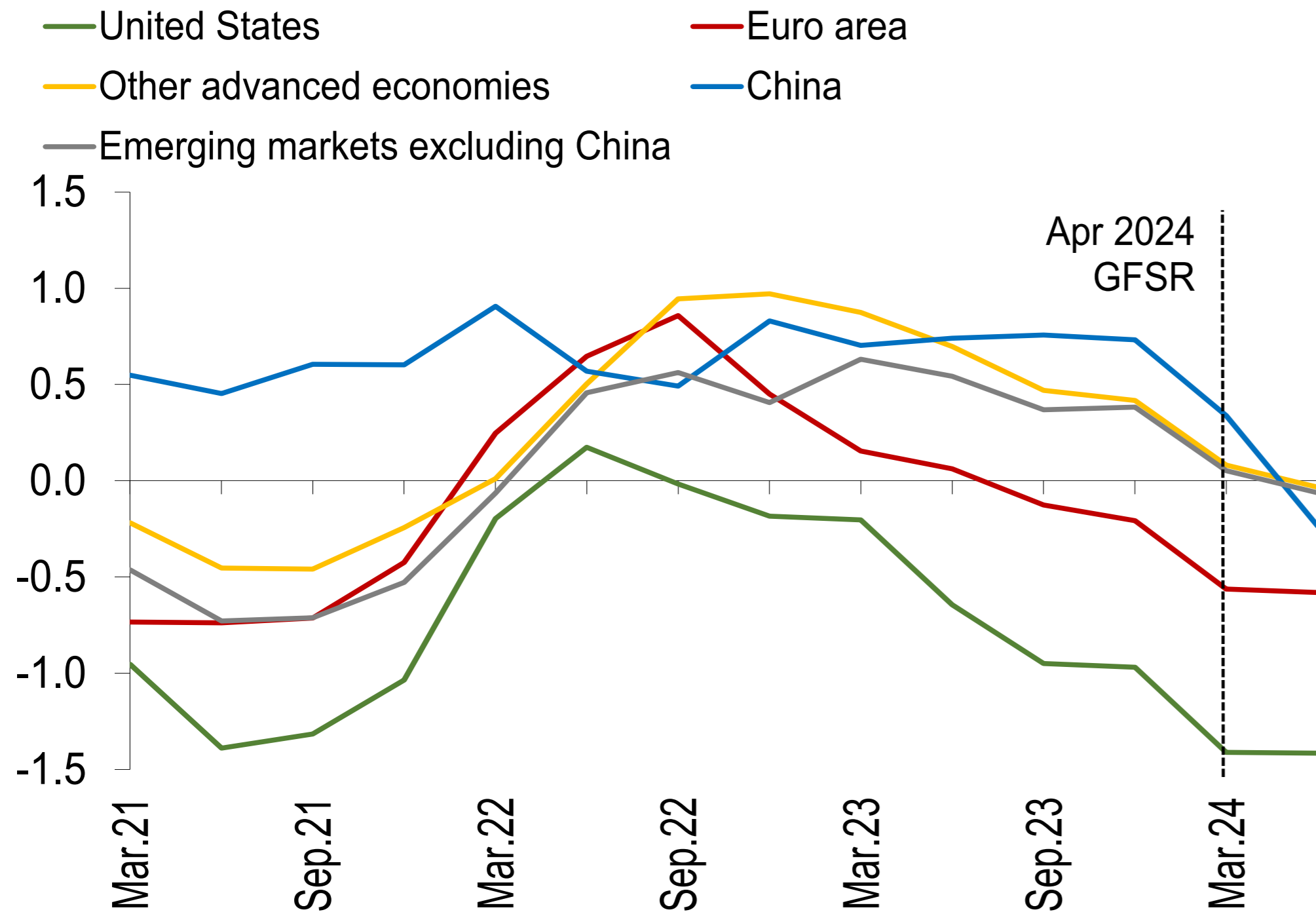


Financial Conditions Have Eased

Financial conditions have eased since the last GFSR, particularly in Advanced Economies,...

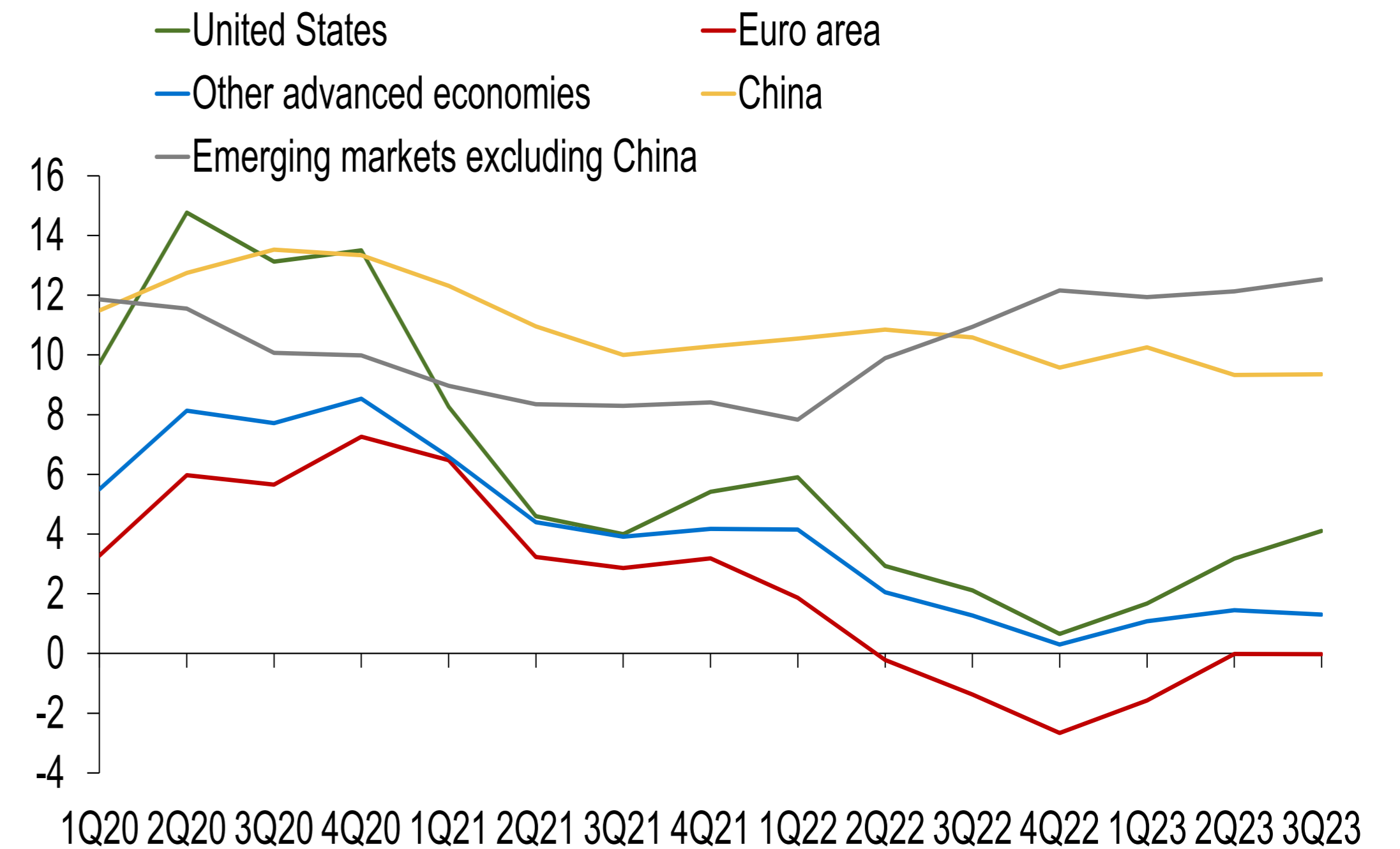
...along with a recovery in credit growth.

Financial Conditions Indices
(Standard deviations over the long-term average)



Note: Weighted by GDP in PPP terms.

Nominal Growth in Credit to Nonfinancial Sectors
(Percent)





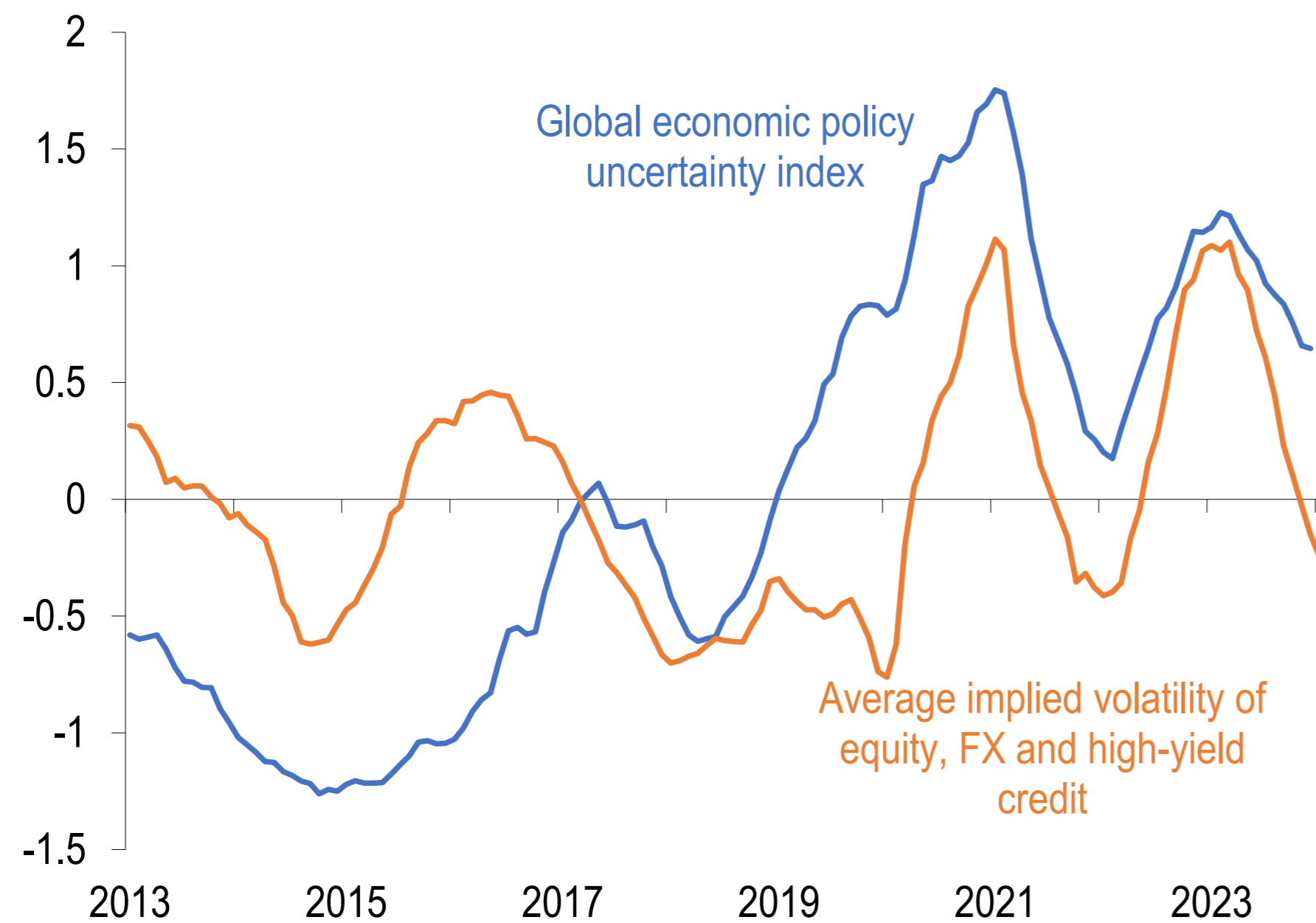
Salient Near-term Risks

Financial Market Volatility Compressed But Economic Uncertainty High

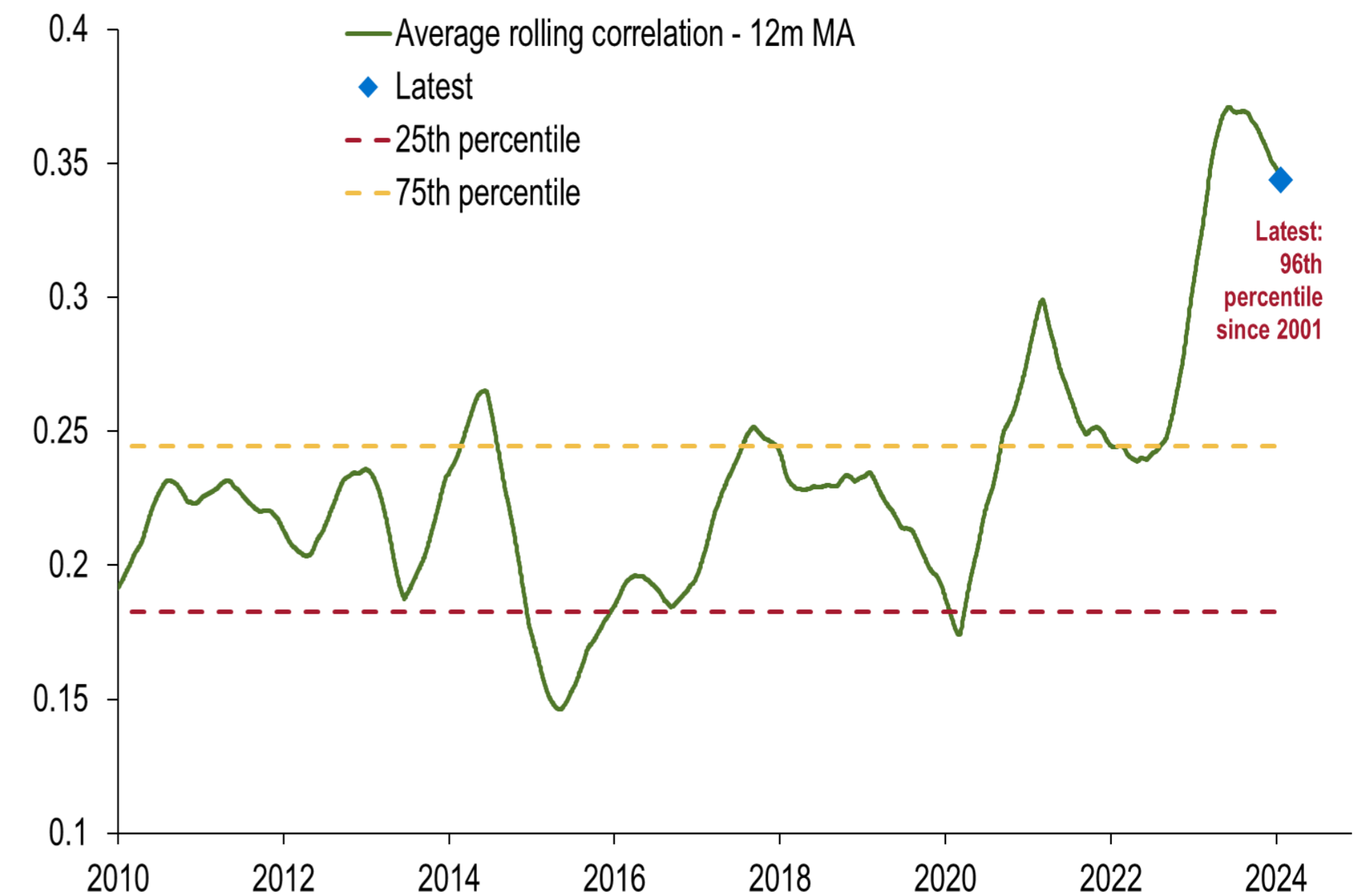
Risk asset volatility has compressed relative to still elevated economic uncertainty

Elevated cross-asset correlations heightening contagion risks

Global Economic Uncertainty and Market Volatility (Index from 2011)



Average Rolling Cross-Asset Correlation (12-month moving average)



Asset Valuations: Are Investors Over-Optimistic?

Credit spreads narrower than fundamentals-implied

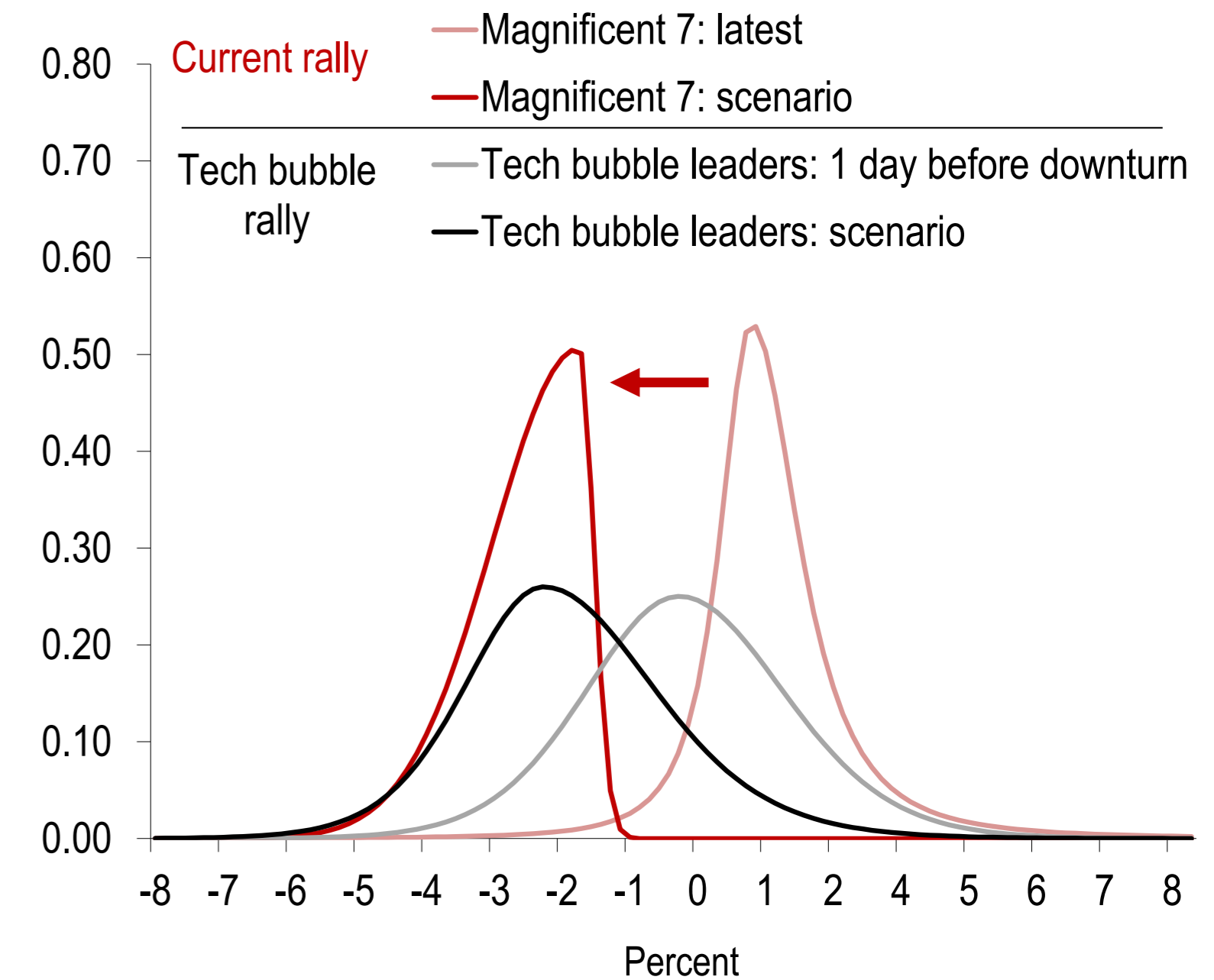
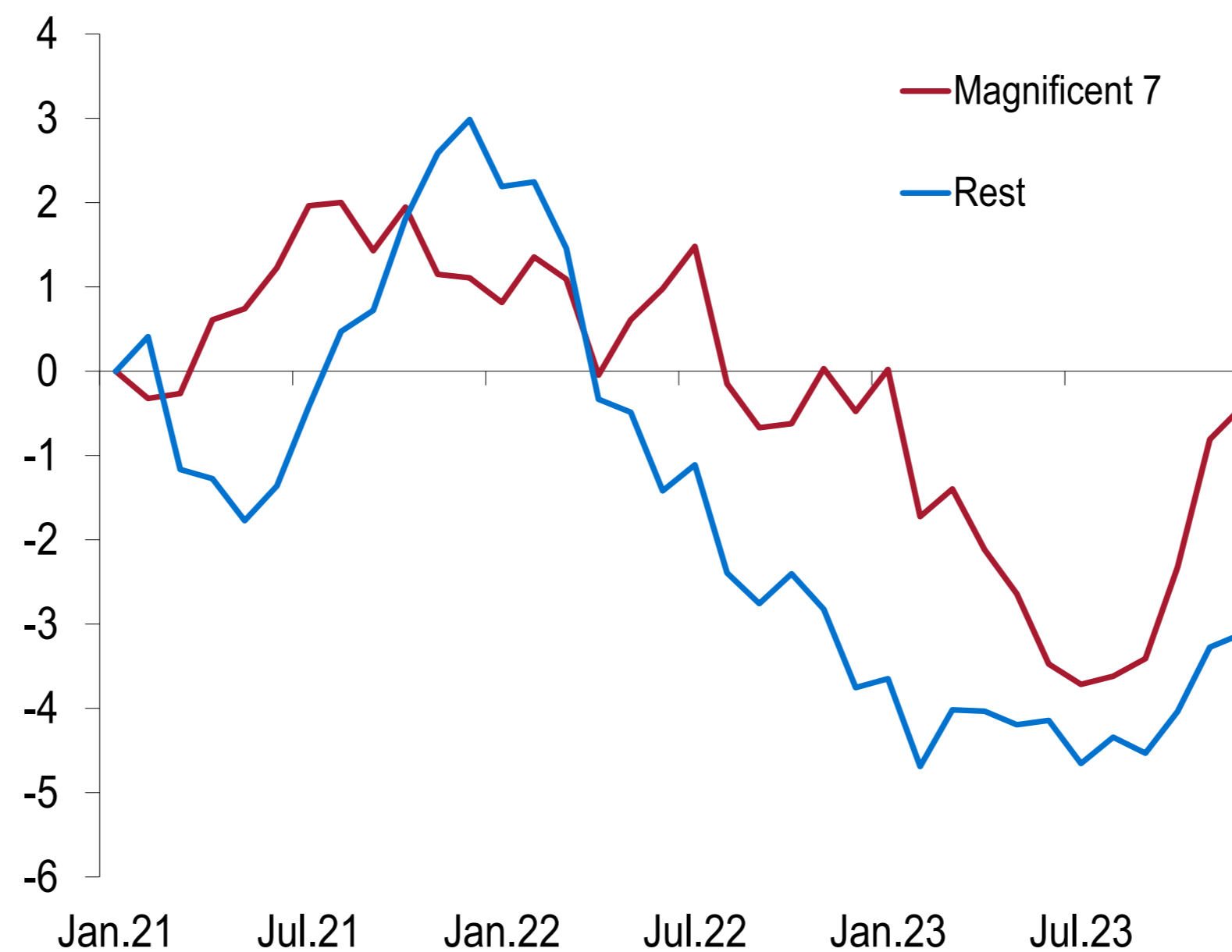
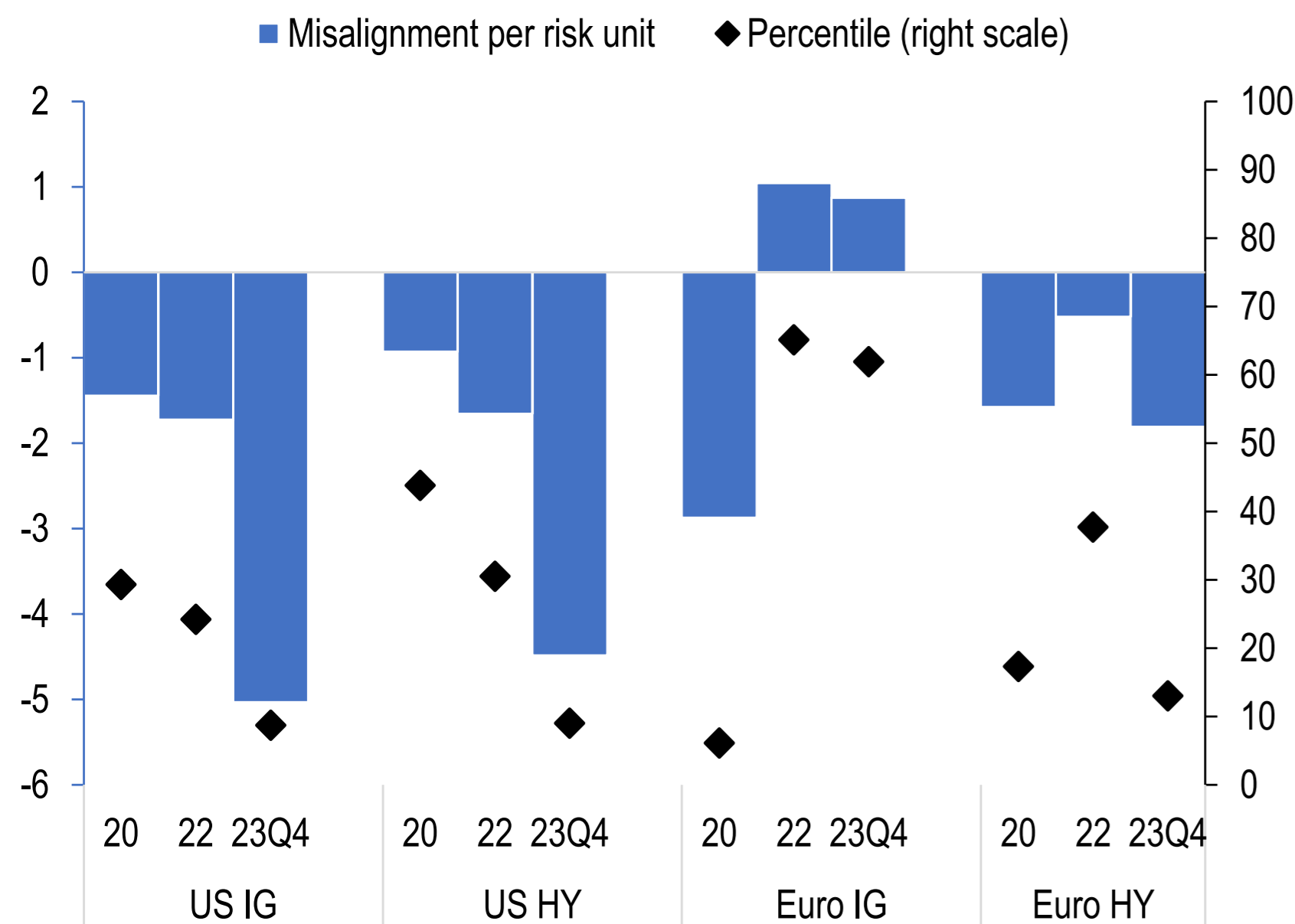
Gains by smaller firms mainly driven by compressed equity risk premium

Large firms' equity returns remain vulnerable to rise in (broader) market risk premium; perhaps more so compared to Tech bubble period

Corporate Bond Spreads Misalignments
(Deviation from fair value per unit of risk; percentile)

Cumulative Changes in Equity Risk Premiums: Mag7 versus Rest of S&P500
(Percentage points)

Daily Equity Return Distributions: Mag7 vs Tech Bubble Leaders
(Probability Density)



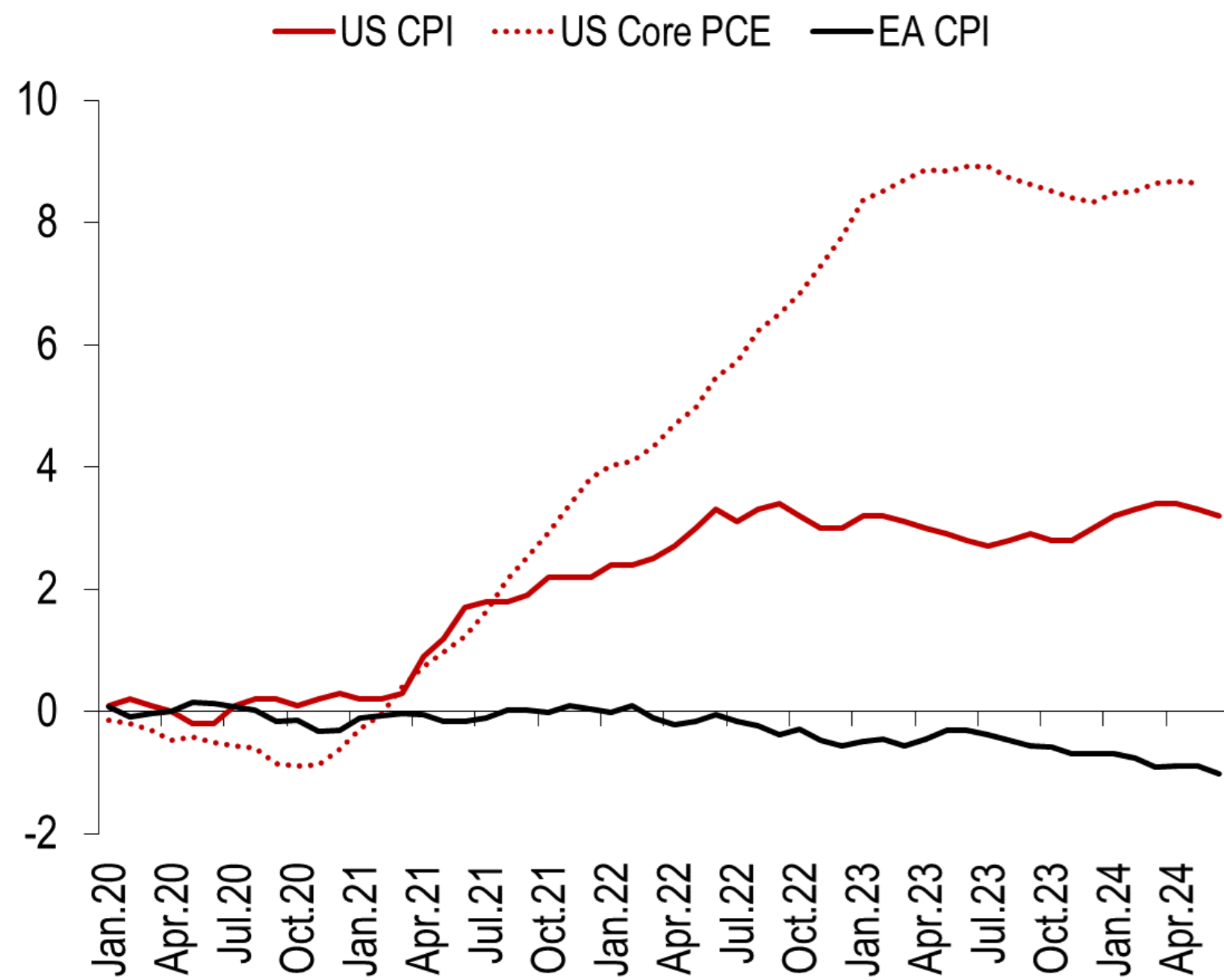
Note: **Magnificent 7:** Microsoft, Apple, NVIDIA, Amazon, Alphabet, Meta, Tesla. **Tech bubble leaders:** Microsoft, Cisco, Intel, Oracle, IBM, Lucent, Nortel. **Scenario:** Materialization of -2.5 percent single day broad market return.

Uncertain Inflation Outlook....

Higher-than-expected inflation outcomes suggest upside risk to US inflation persisting, with market expectations of inflation trending up in general, and uncertainty around most likely outcome remaining elevated

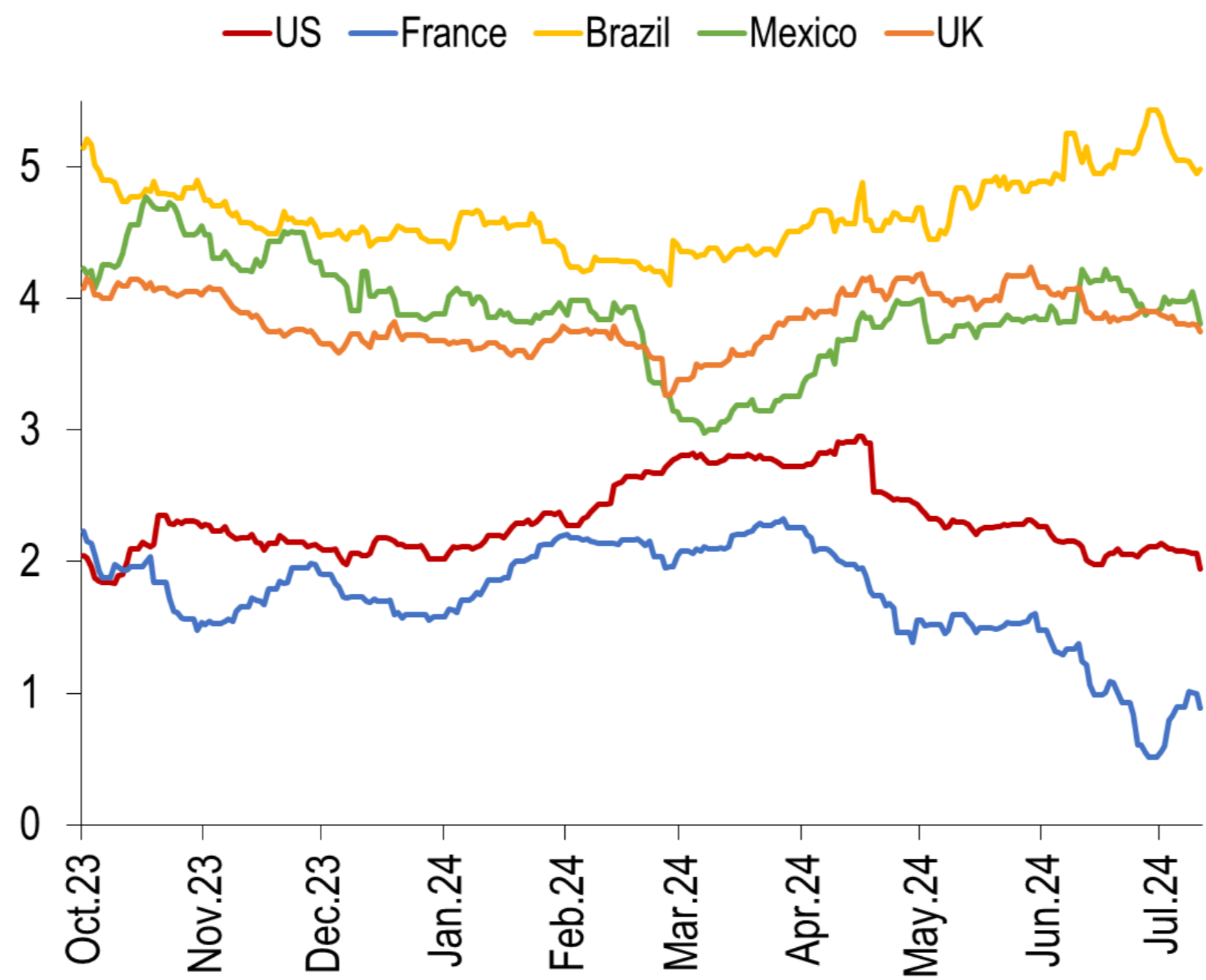
Inflation Surprises

(Cumulative since 2020; percentage points)



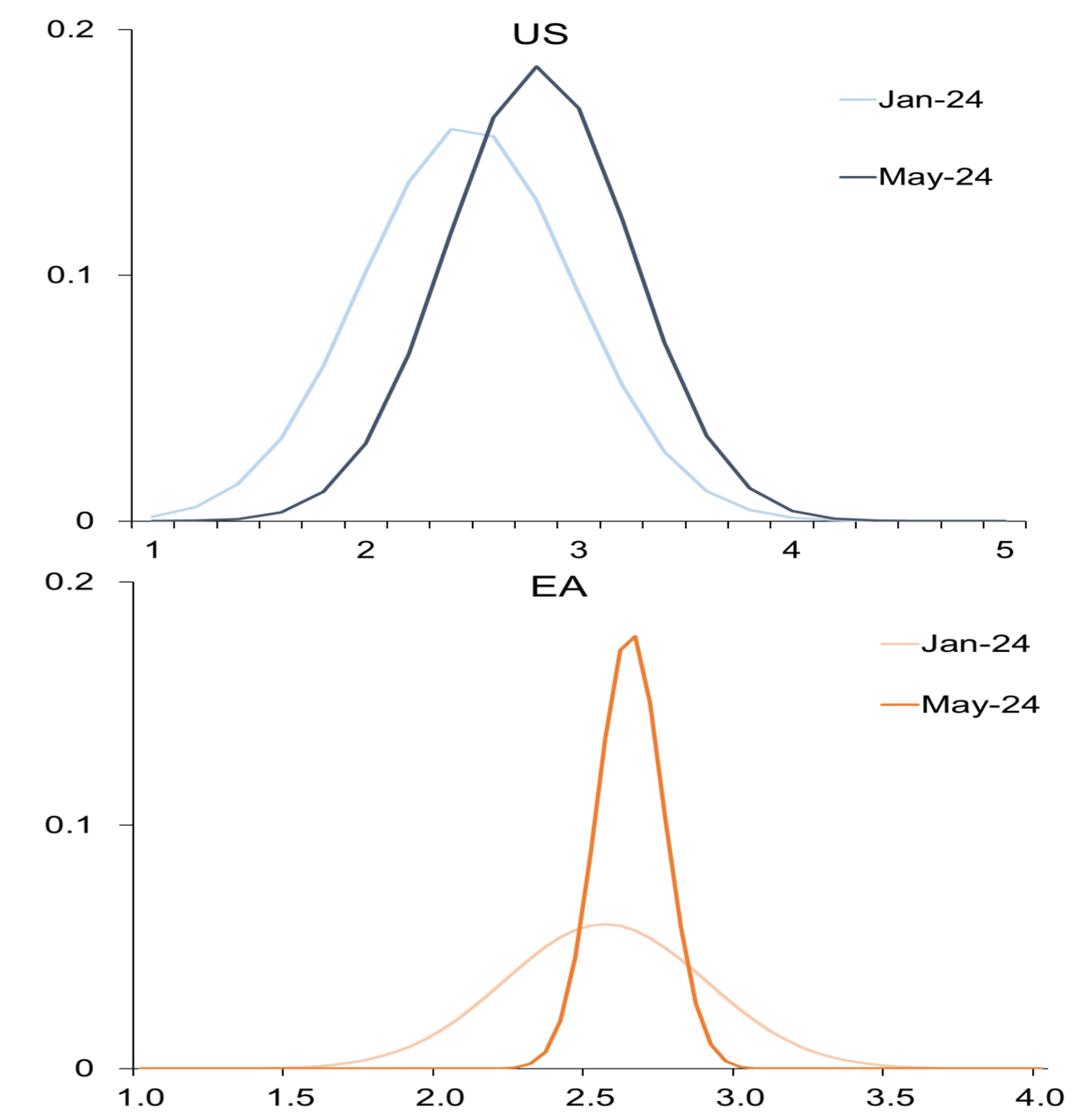
Market Expectations of Inflation

(Average over the next two years; percent)



Distribution of Analysts' Forecasts: Core Inflation for 2024

(Probability density; percent)



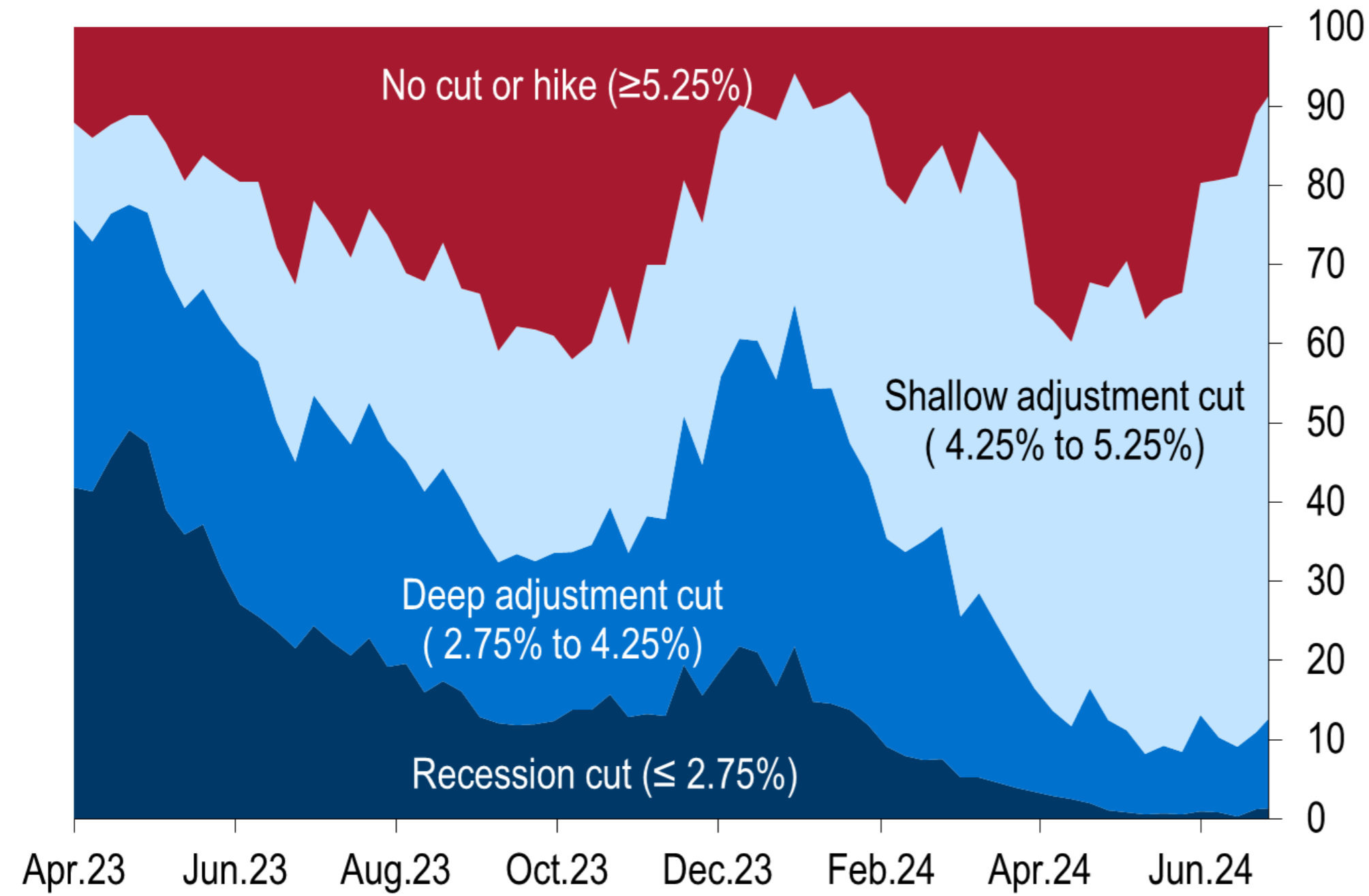
Note: In left panel, CPI surprise is equal to reported CPI minus Bloomberg's Median Consensus Forecast for a given month. EA series is simple average of CPI surprise for Germany, Spain, France, Italy, Switzerland, Norway, and Sweden. Expected inflation in the middle panel corresponds to breakeven inflation rates, derived from subtracting the two-year inflation-linked government bond yield from nominal yield. The right panel uses survey forecast responses submitted by economists and market participants to Bloomberg.

.... Keeping Policy Uncertainty High

Uncertainty around monetary policy outlook...

...translating to elevated interest rate volatility in both the US and euro area.

Option-Implied Probabilities of December 2024 SOFR Outlook (Percent)



Option-Implied Interest Rate Uncertainty (Basis points, annualized)



Note: Based on options on the December 2024 3-month SOFR (Secured Overnight Financing Rate) futures.

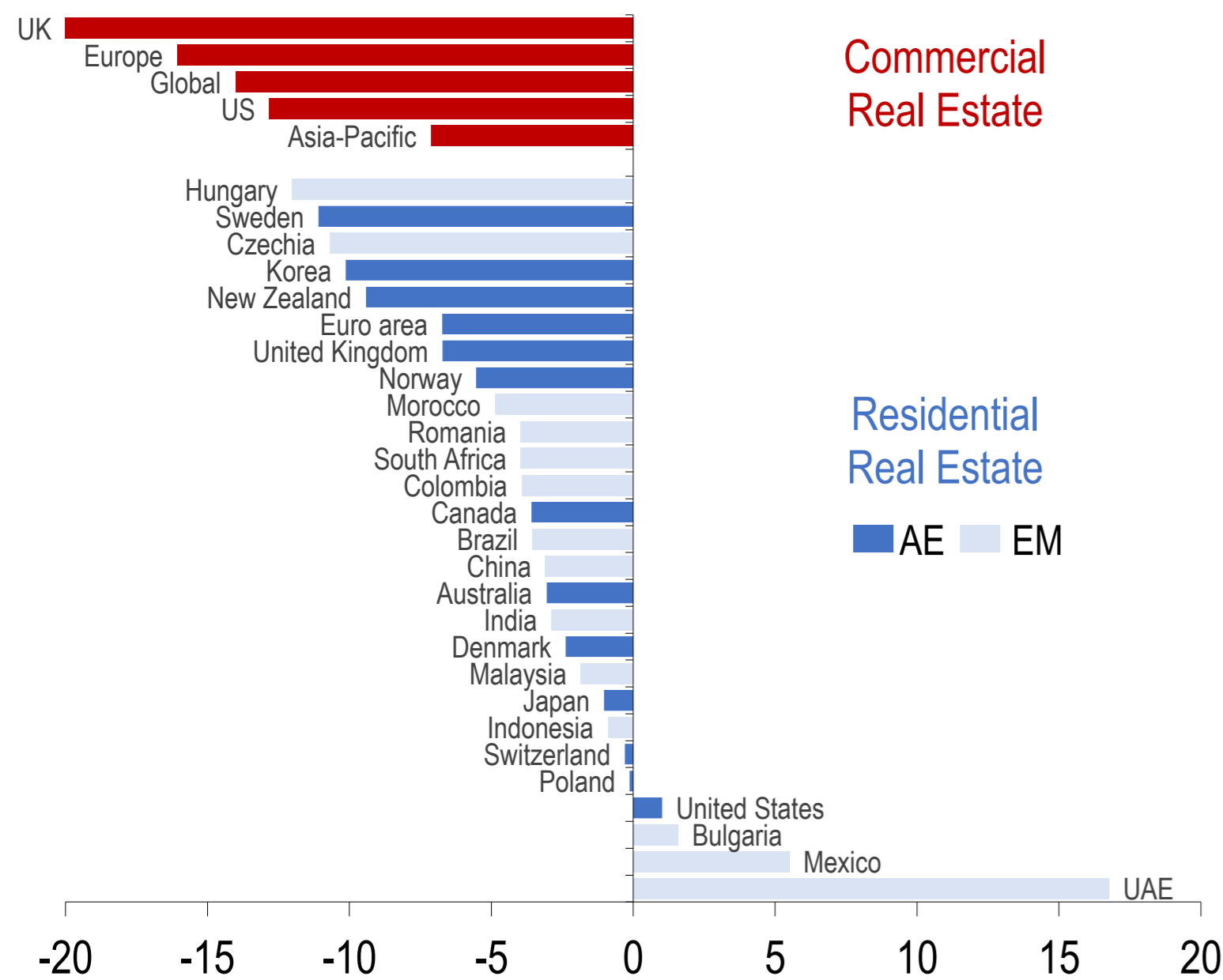
Global Property Sector Adjustment Continues

Global real estate sectors continued to reprice

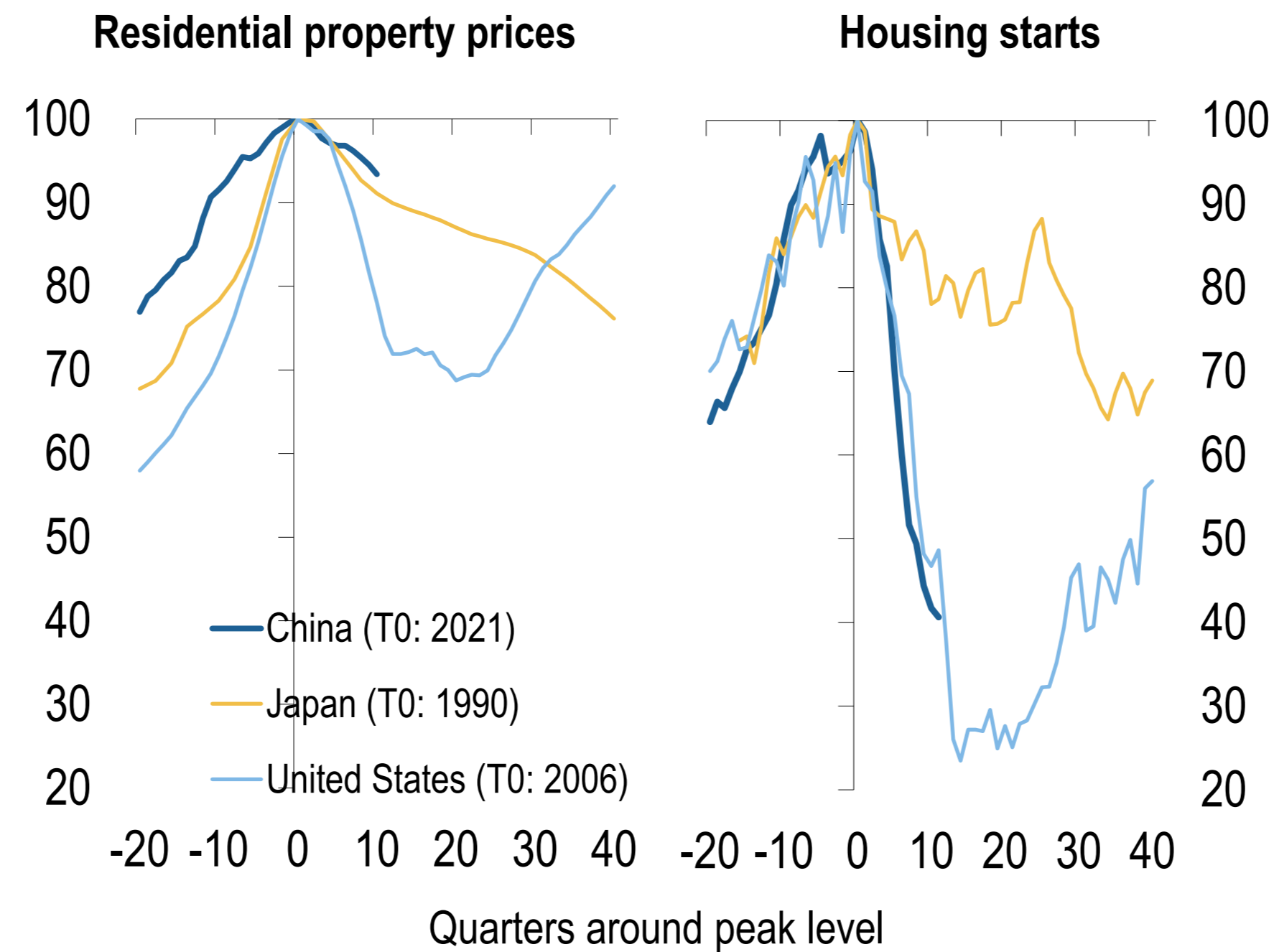
In China, property market has yet to bottom out...

... as developer financing remains challenging, potentially prolonging the adjustment process.

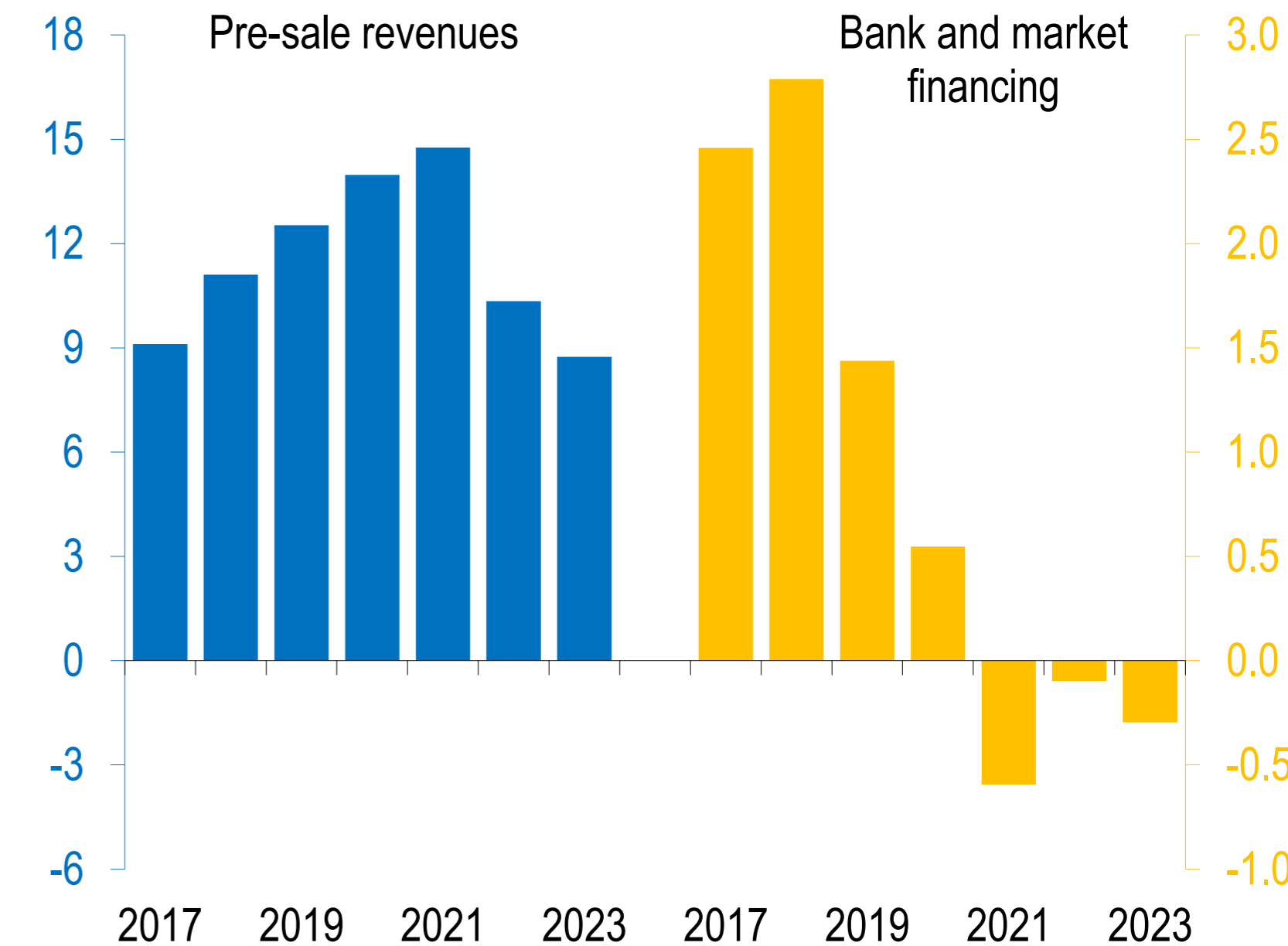
Global Real Property Prices
(Percent, year-over-year)



China versus Other Historical Housing Market Correction
(Index to peak price and housing starts)



Financing for Property Developers
(RMB, trillions)



Note: In middle panel, China price is the average of primary and secondary market prices across 70-city. Housing start in units for United States and in square meters for China and Japan.

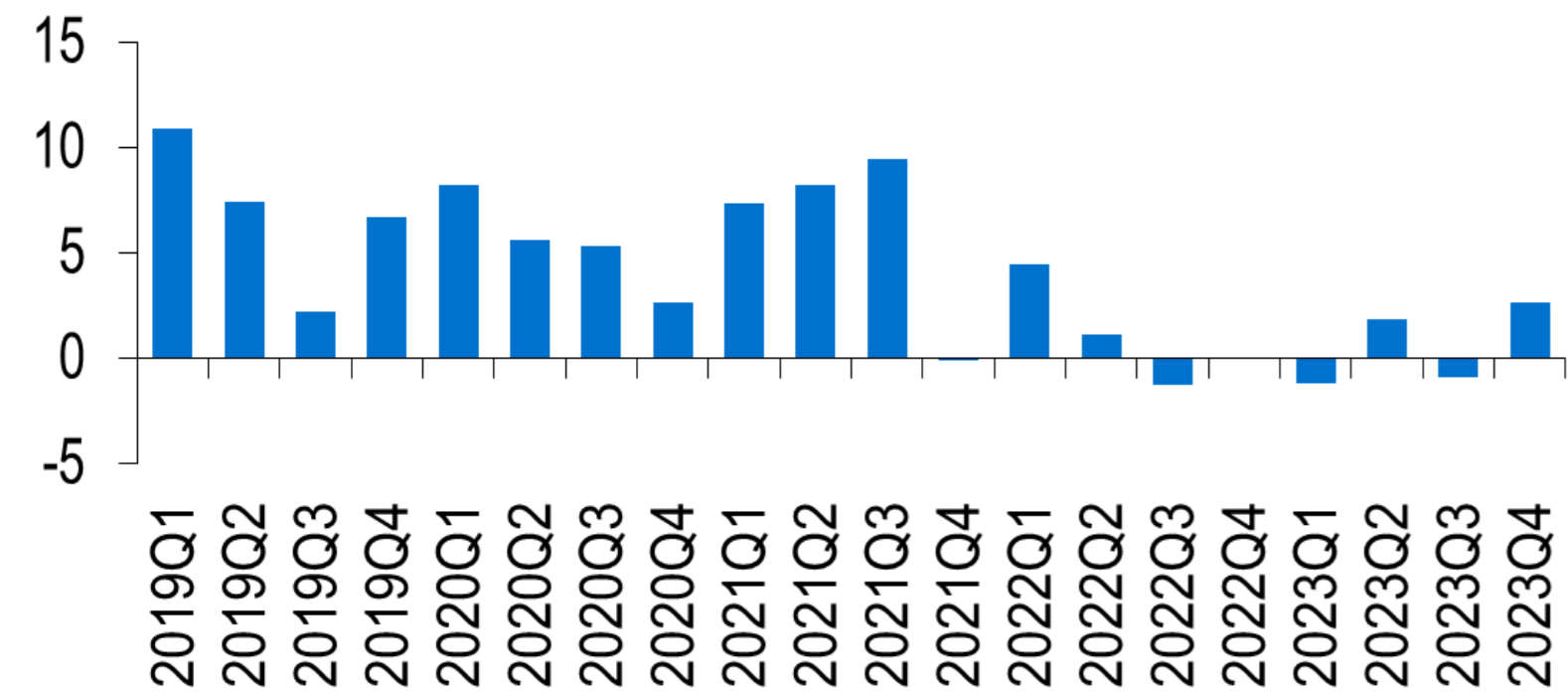


Medium-term Vulnerabilities

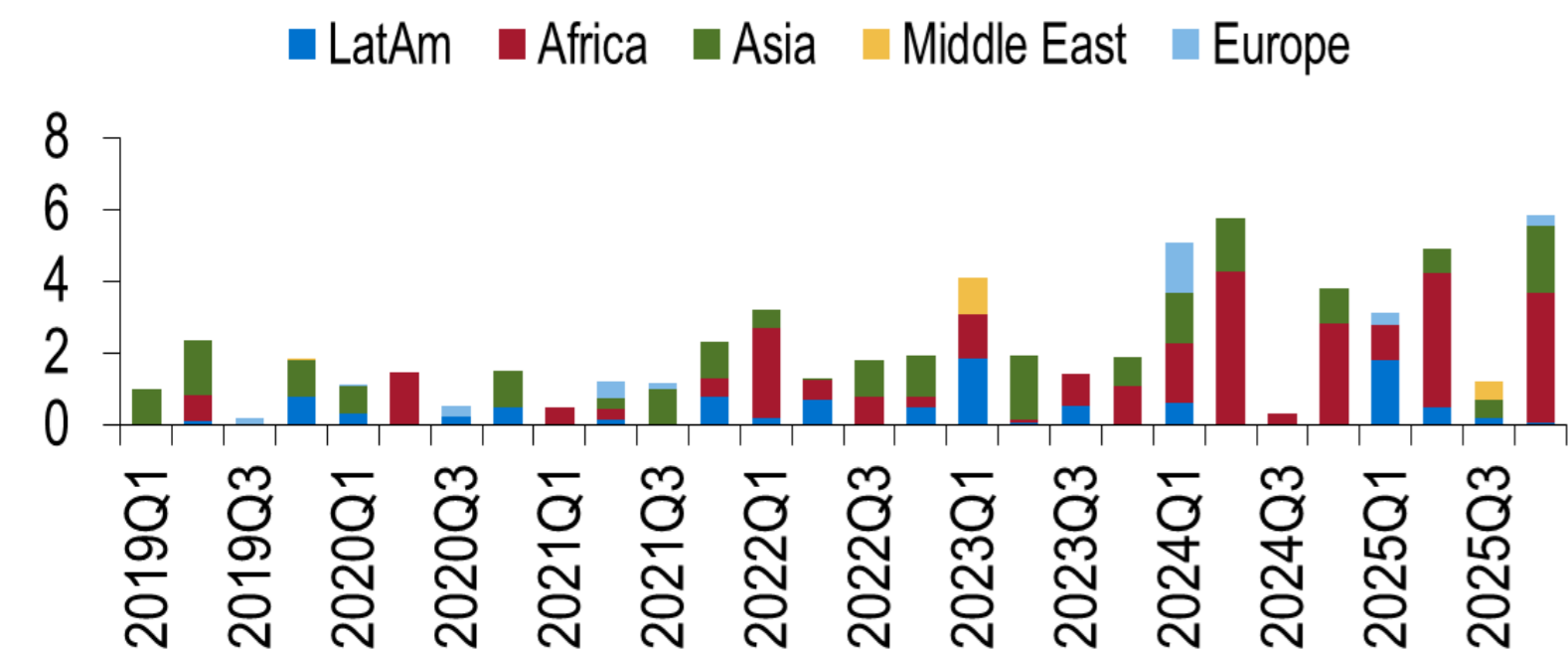
Financing and Fiscal Challenges Remain for EMs

In frontier market and LICs, total hard currency issuance has barely kept pace with maturing bonds

Net Issuance (USD bn)

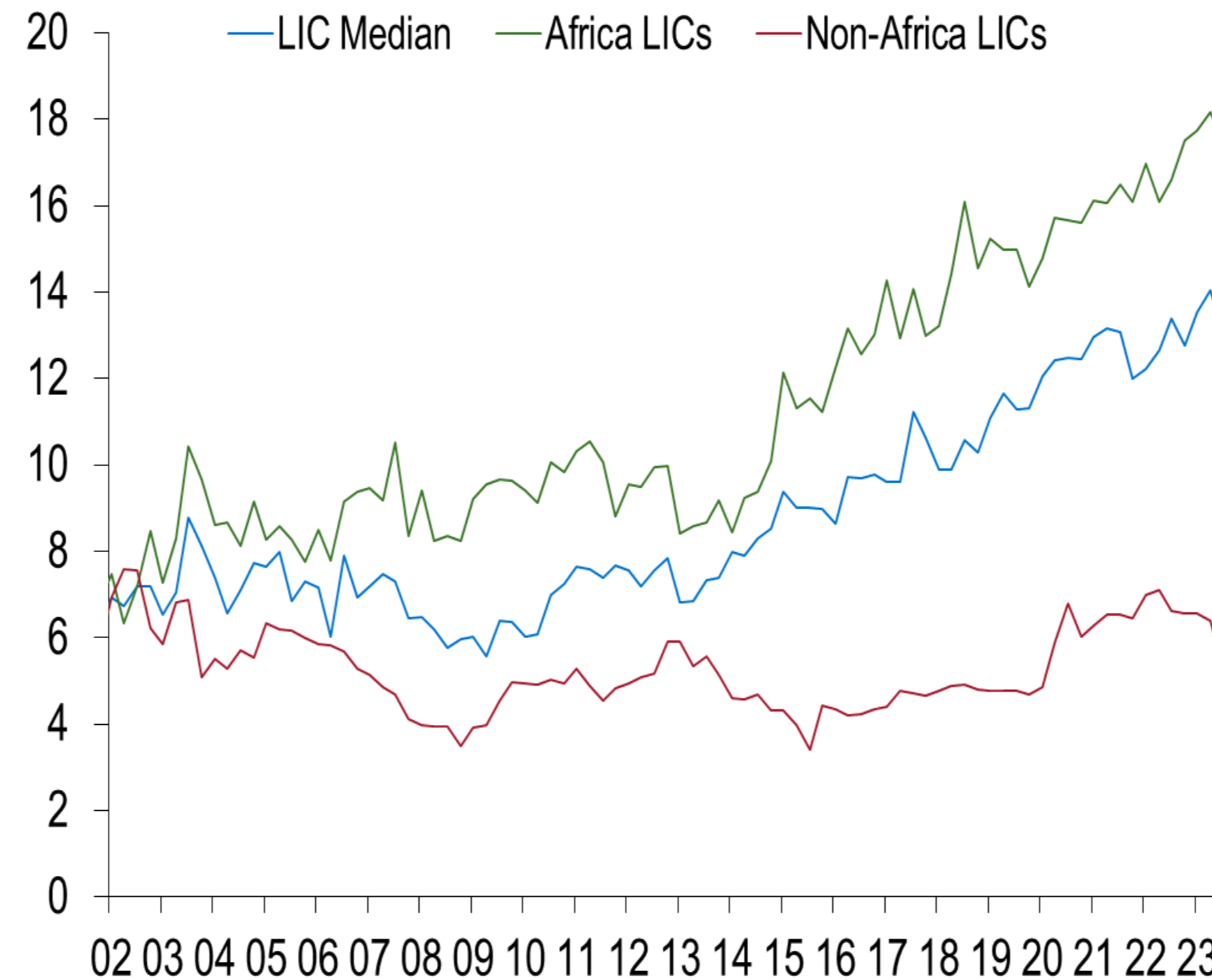


Maturing Hard Currency Debt (USD bn)



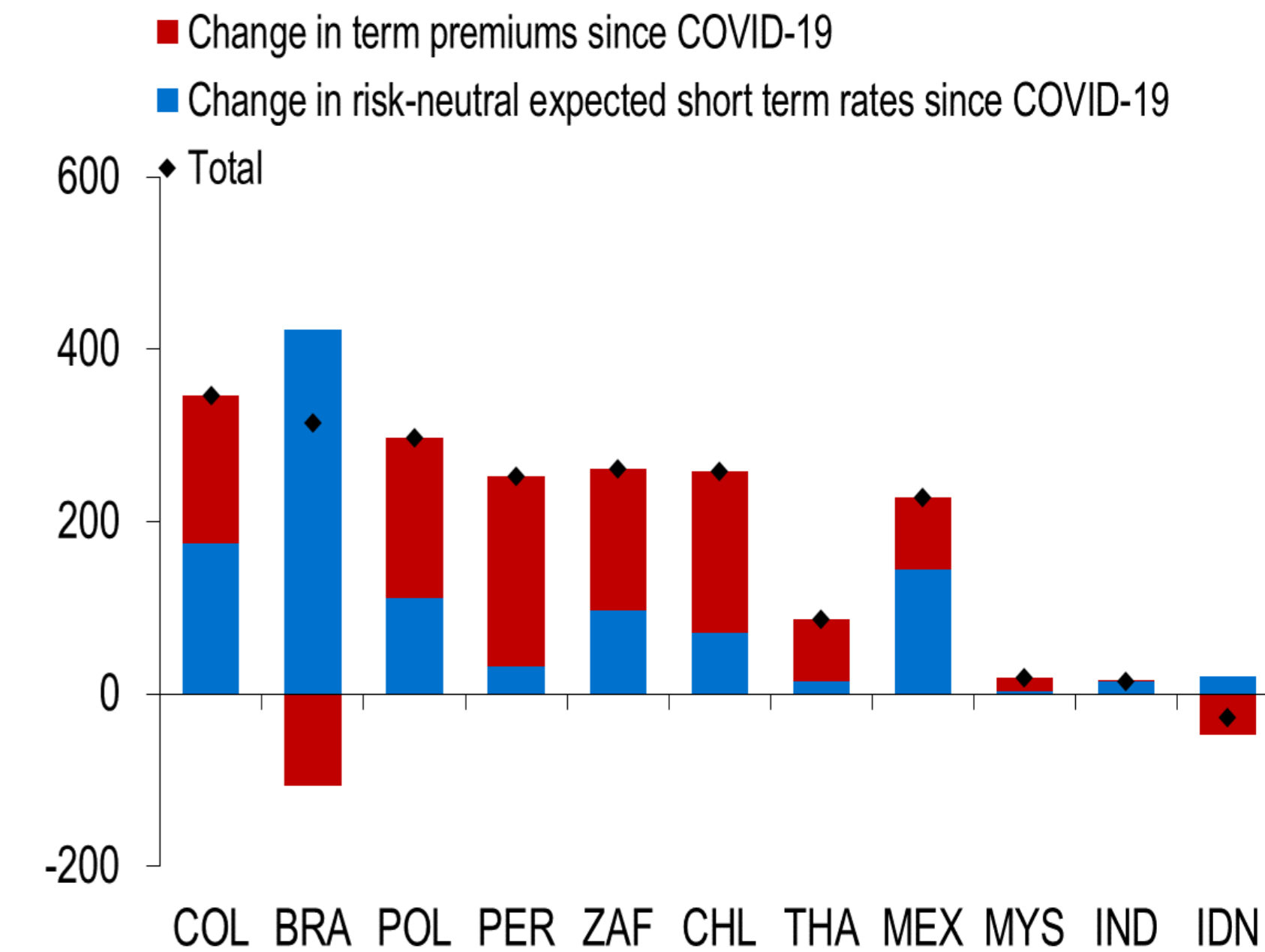
... while sovereign-bank nexus has strengthened further.

Bank Claims on Central Government (Percent of bank assets)



In major EMs, local currency bond yields remain high, as term premiums widen following higher bond supply

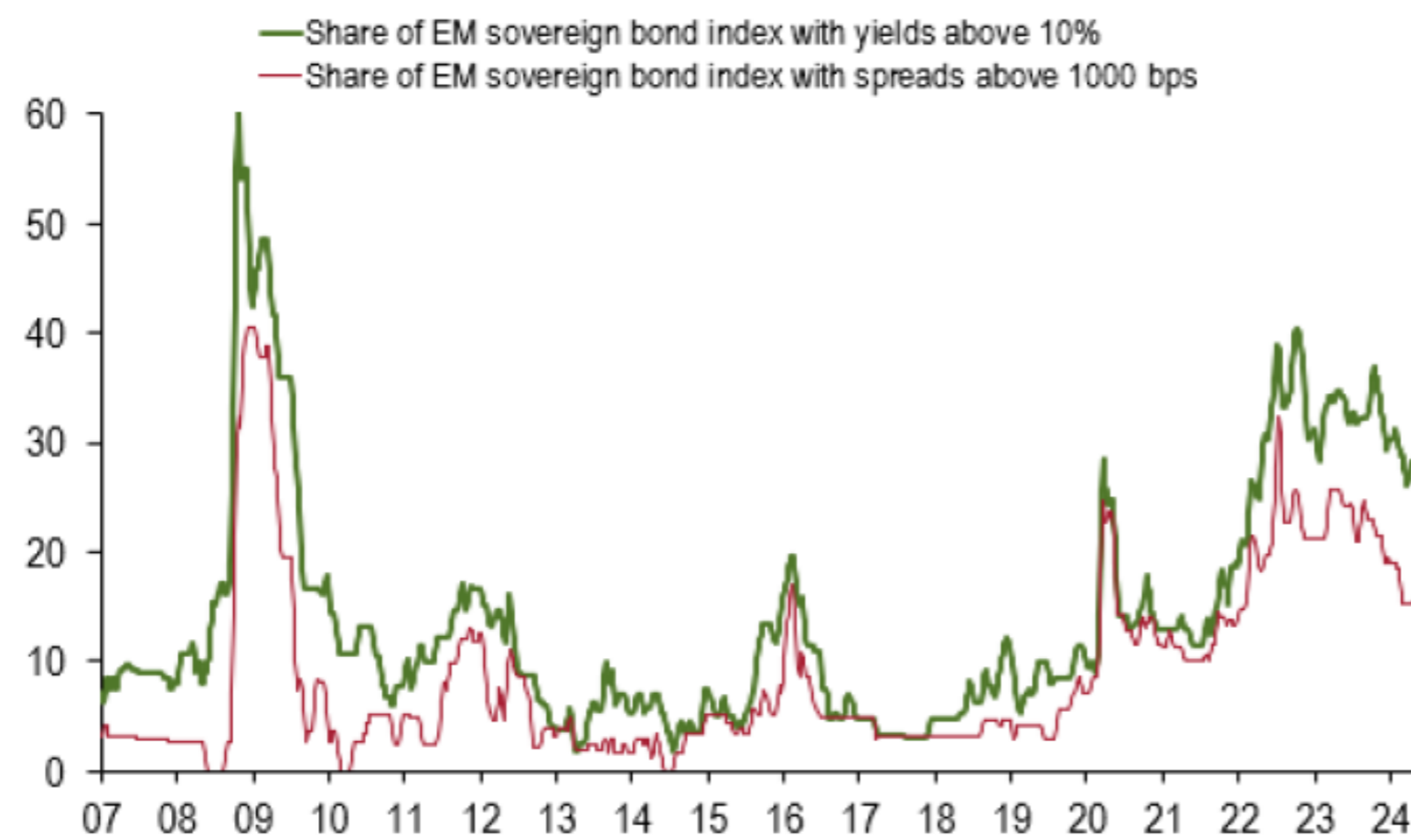
Decomposition of Changes in 10-year Yields: Since 2019Q4 (Percent)



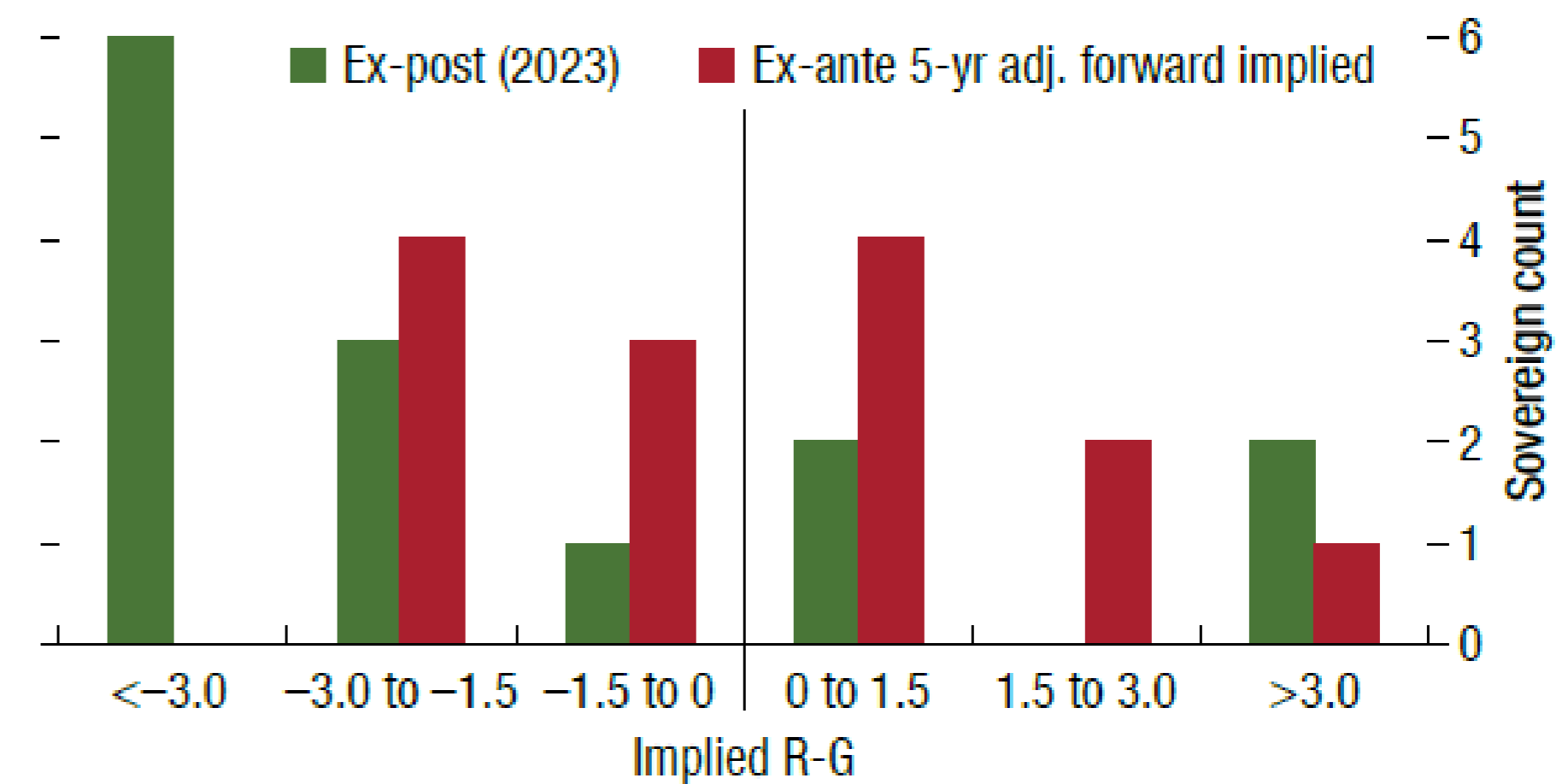
Note: Colombia [COL], Brazil [BRA], Poland [POL], Peru [PER], South Africa [ZAF], Chile [CHL], Thailand [THA], Mexico [MEX], Malaysia [MYS], India [IND], Indonesia [IDN].

Financing and Fiscal Challenges Remain for EMs (cont'd)

Share of Distressed Issuers in EM Bond Index
(Percent, 3-week average)



EM Sovereigns Real Interest Rates Minus Real Growth
(Number of sovereigns)

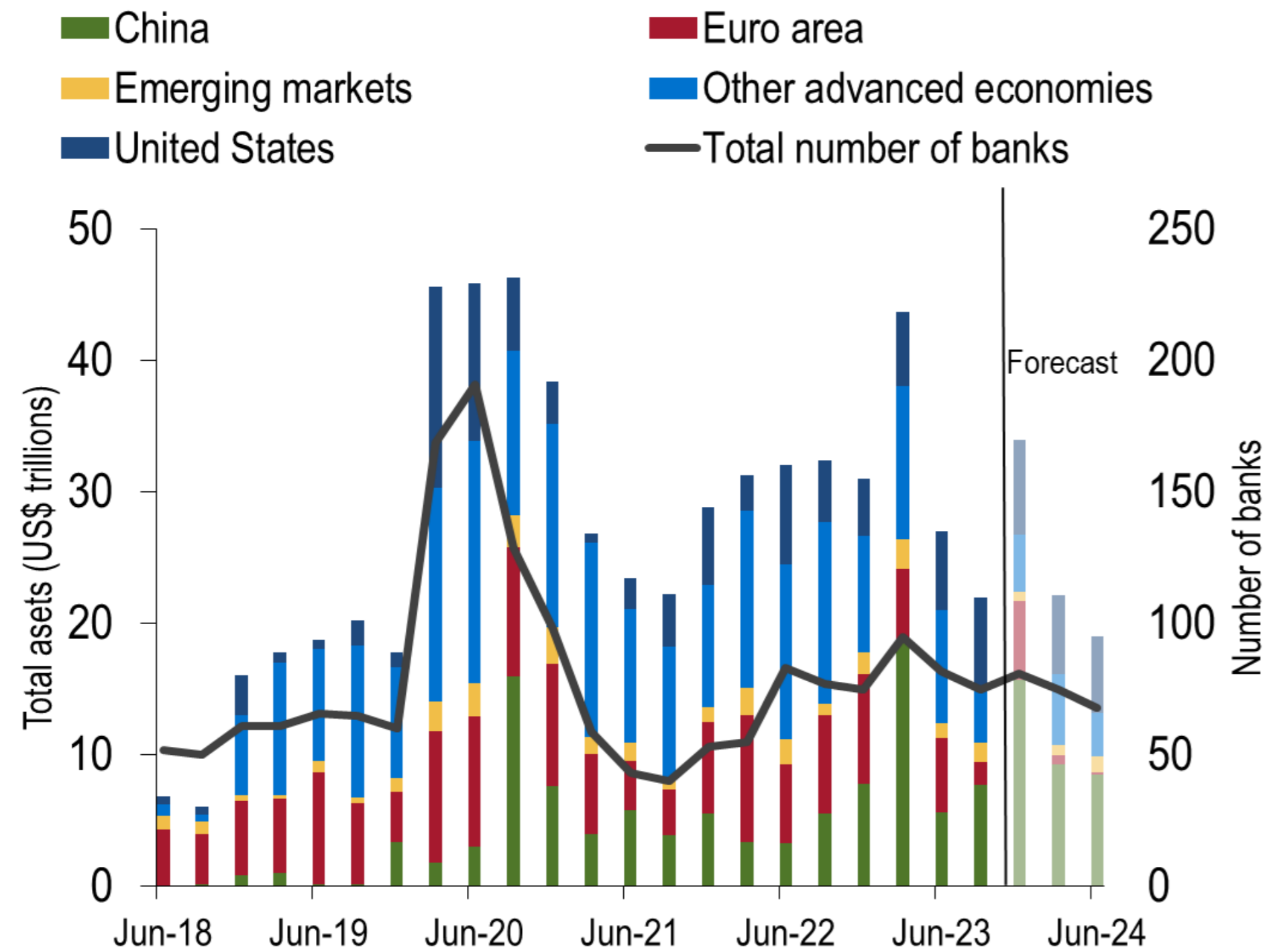


Banking Sector Vulnerabilities

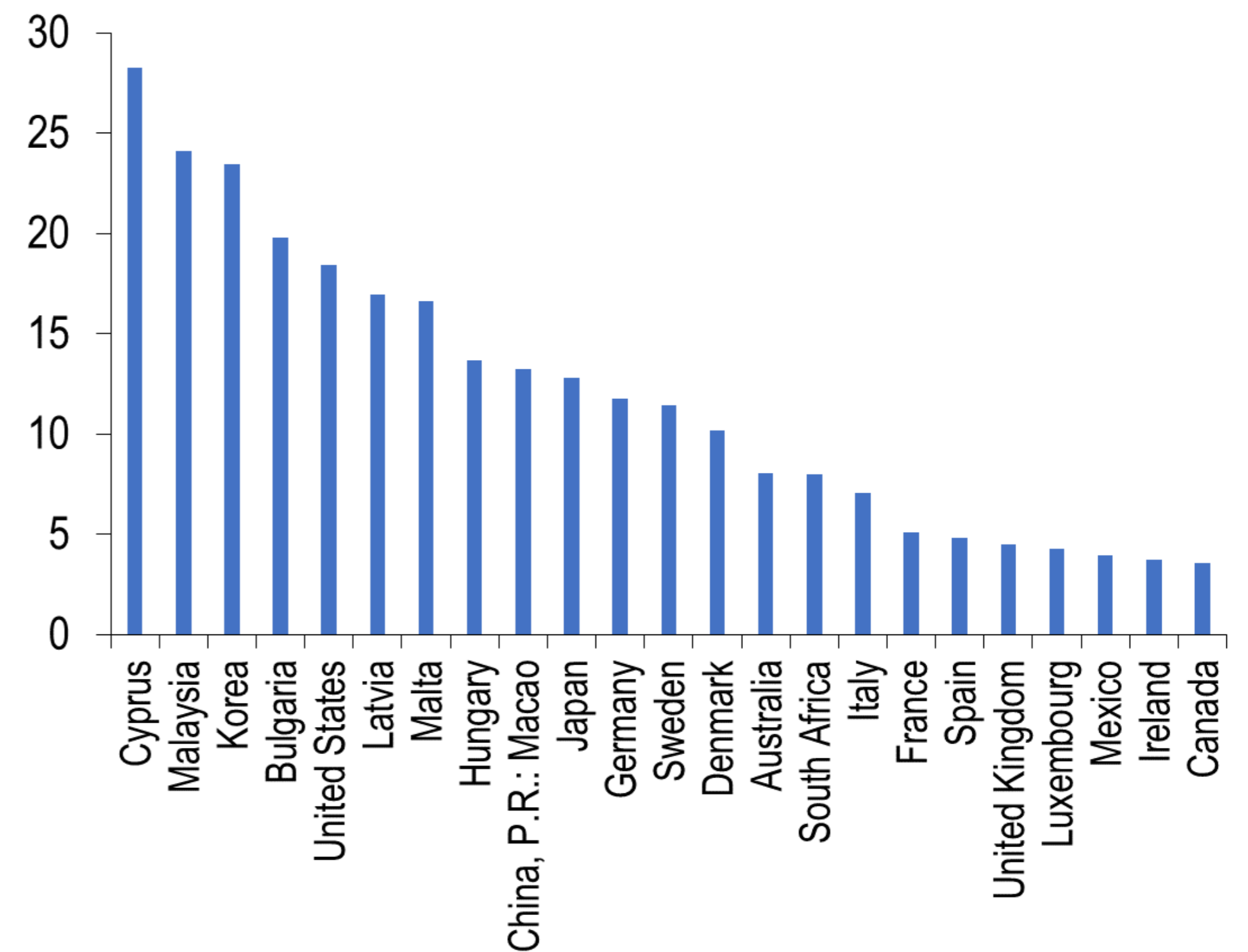
Weak tail of banks remains

Many banking systems have sizable CRE exposures

Total Assets of Vulnerable Banks Based on Key Risk Indicators by Region
(USD, trillions)



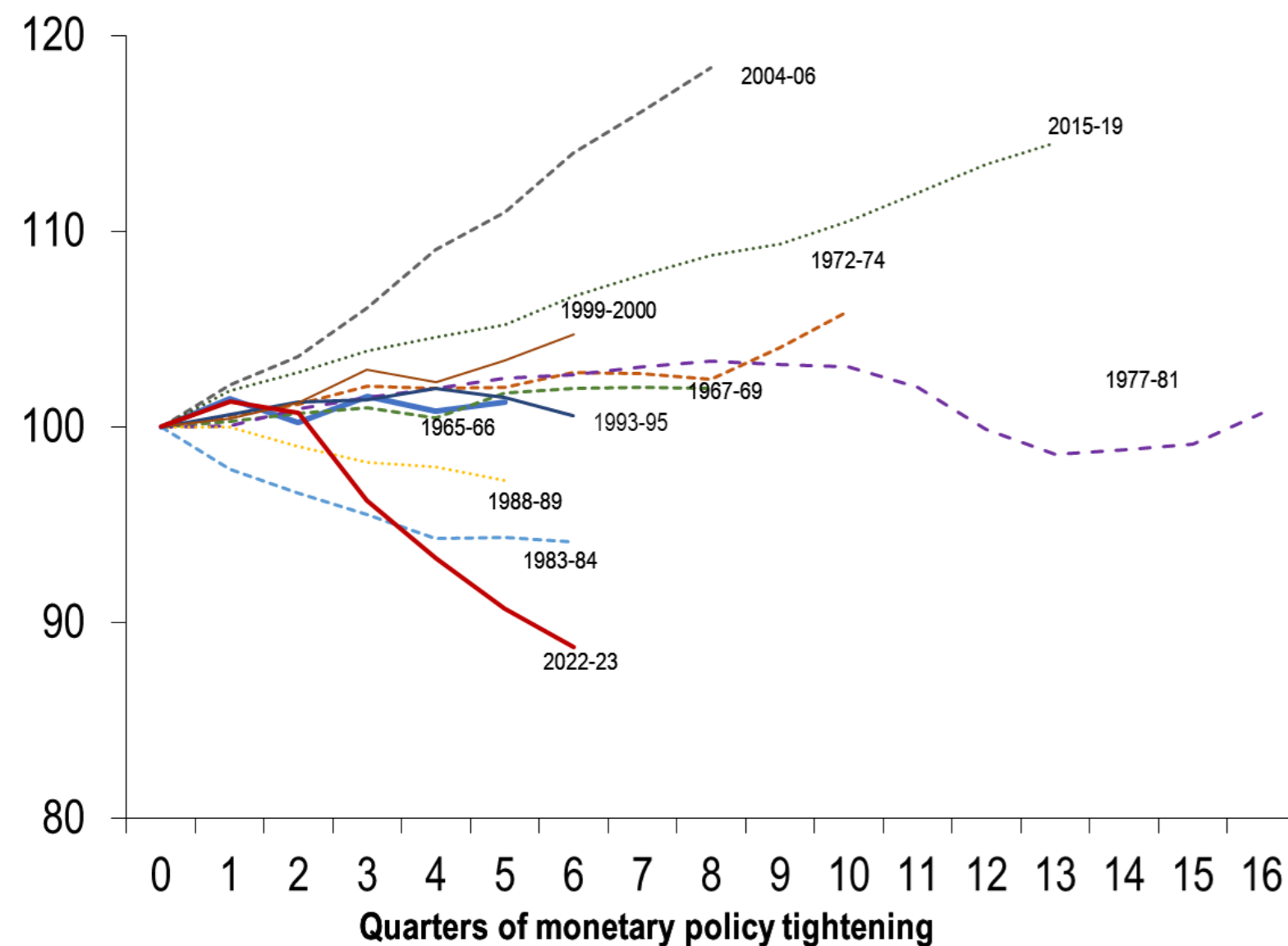
Commercial Real Estate Exposure to Total Loans
(Percent)



More Adjustments in CRE Maybe Forthcoming

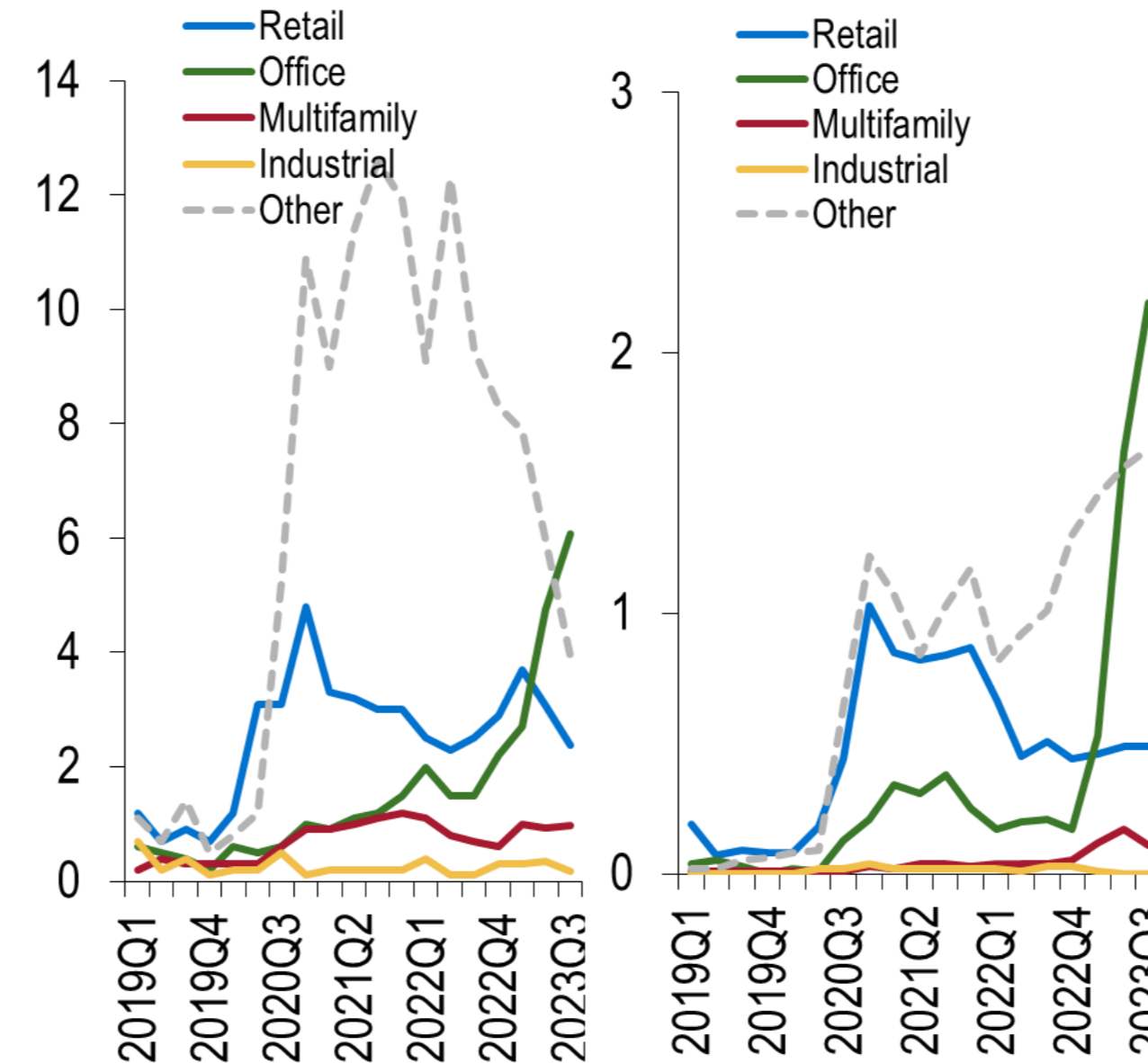
CRE valuations have plummeted more in the present monetary policy tightening cycle than in previous episodes.

CRE Price Trajectories during Rate Hike Cycles
(Index = 100 at beginning of cycle)



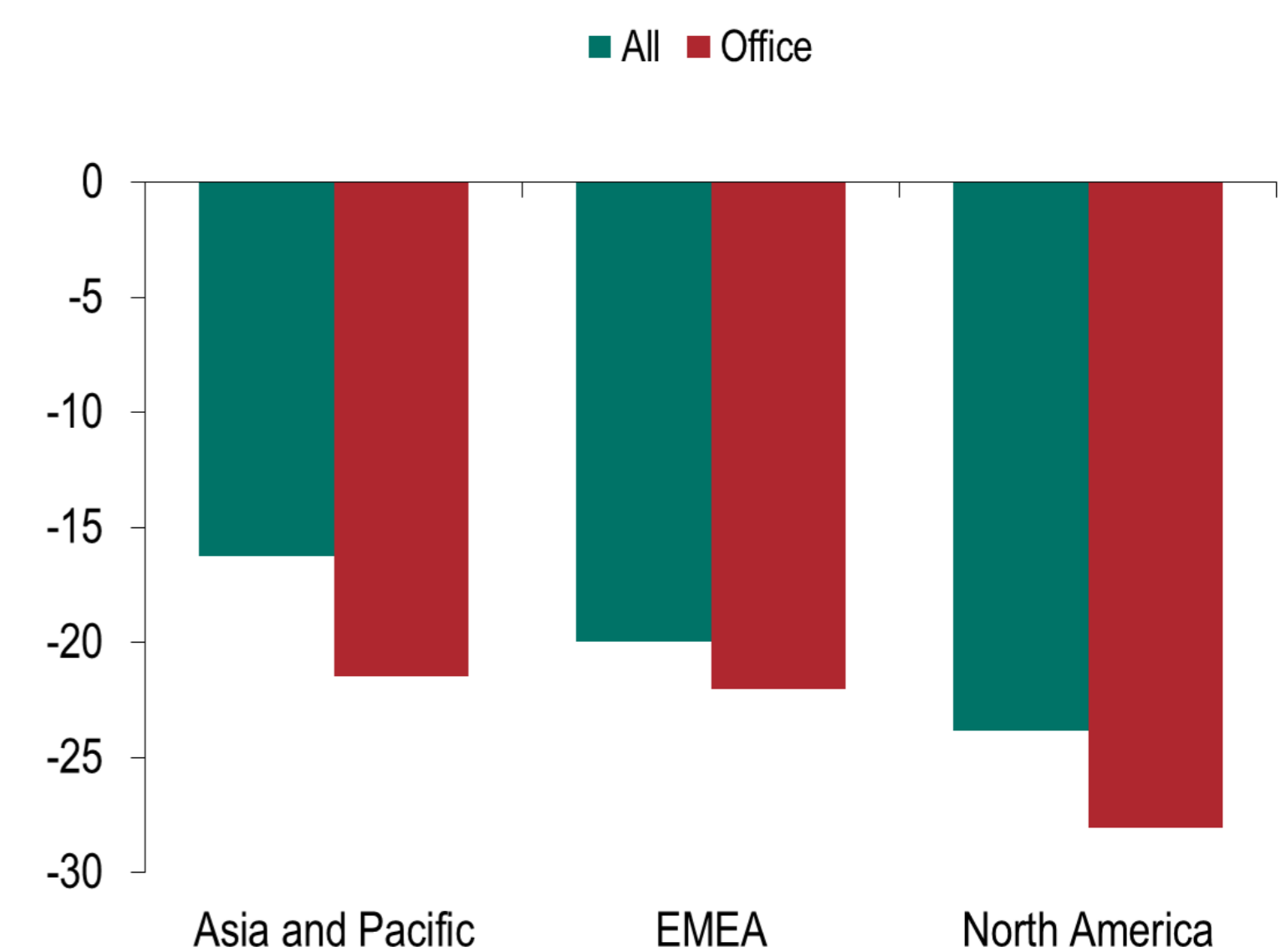
... while delinquencies in the office sector and bank net charge offs in multiple sectors surged.

CMBS Delinquency Rate and Banks Net Charge-Offs, by Property Type
(Percent)



... increasing downside risks to CRE prices.

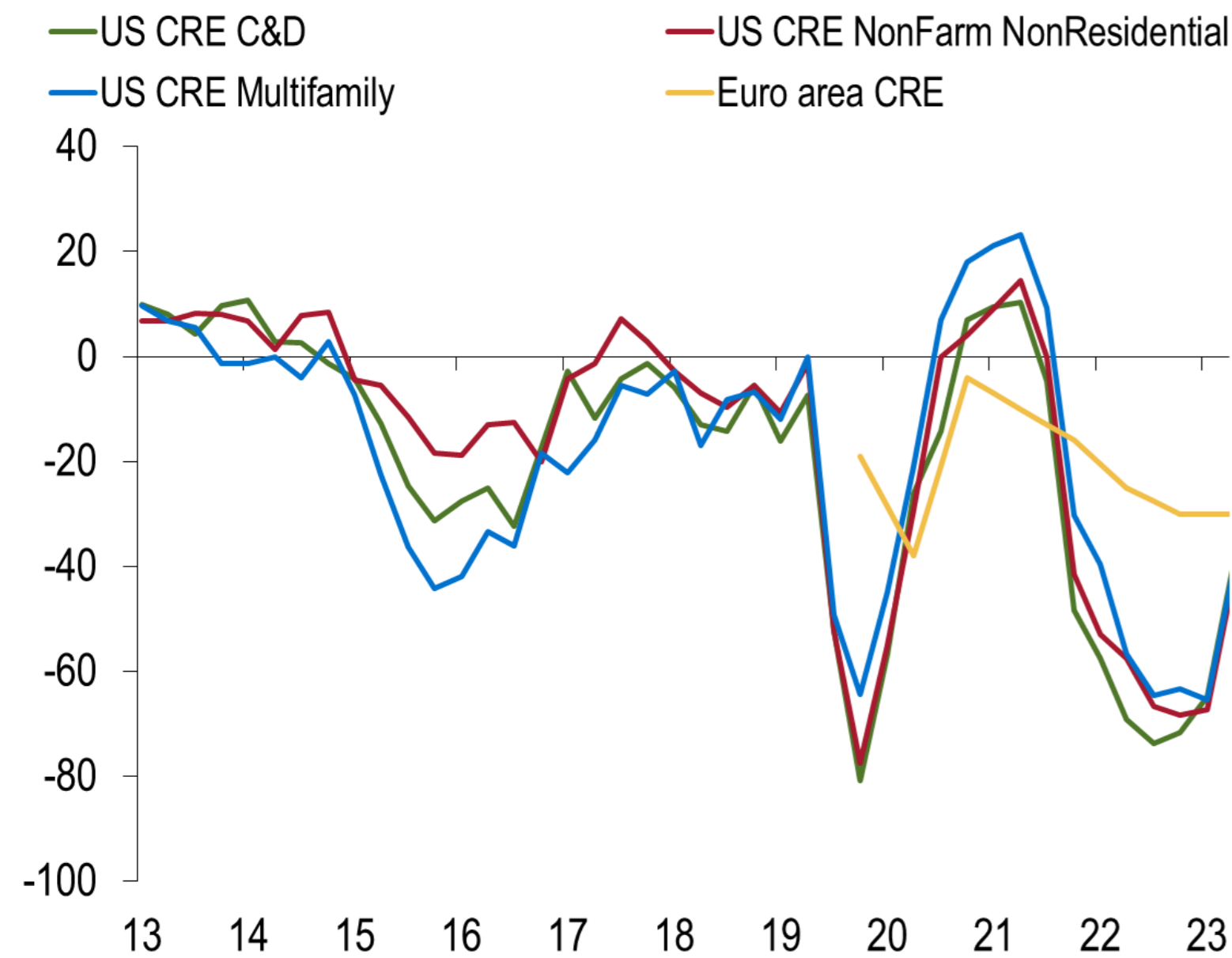
CRE-Price-at-Risk Model
(Percent, three-years-ahead real cumulative growth)



CRE Challenges Faced by US Banks

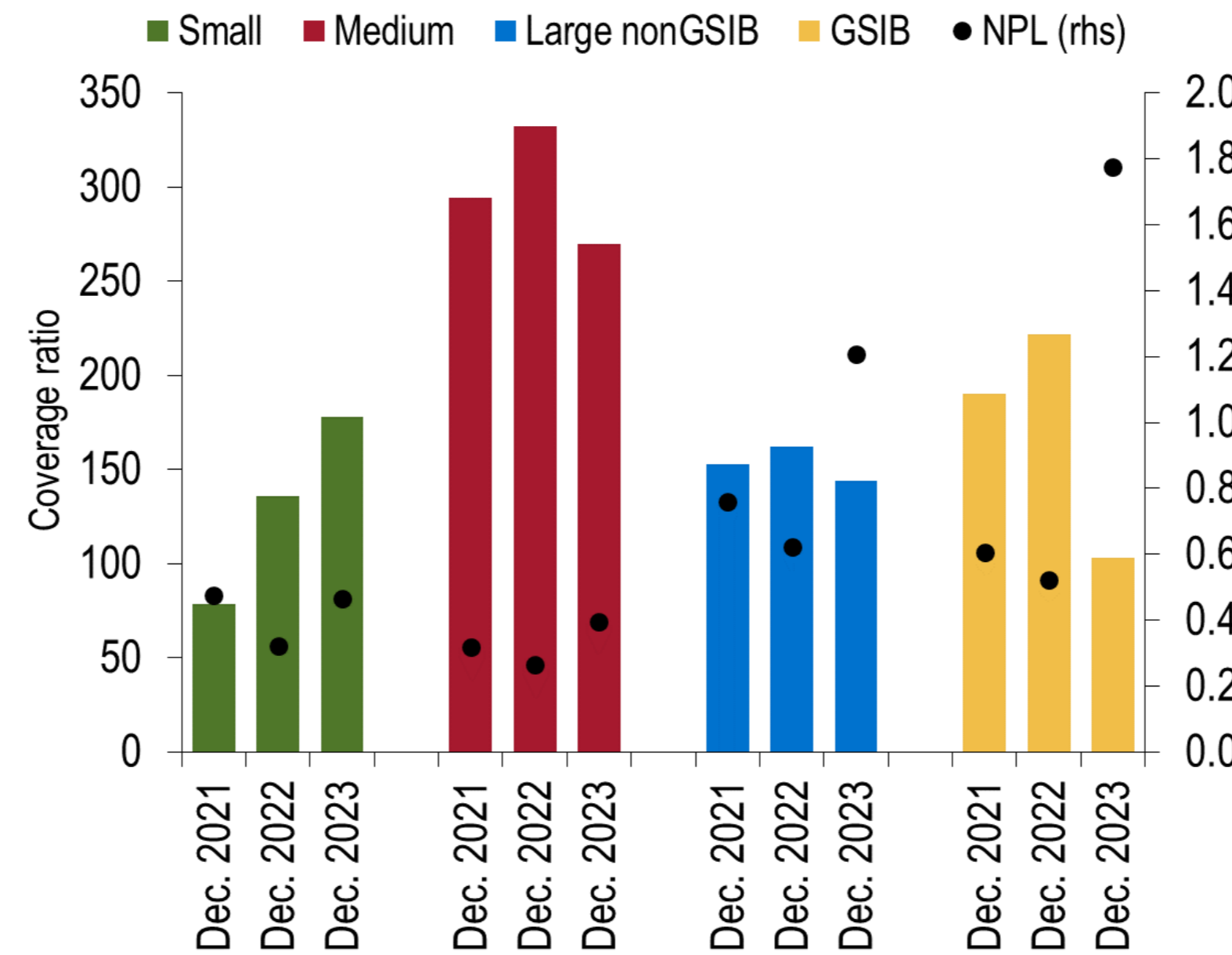
CRE lending standards tightened both in CRE NPLs are rising while coverage ratios the euro area and the United States.

CRE Lending Standards
(Percent of net respondents)



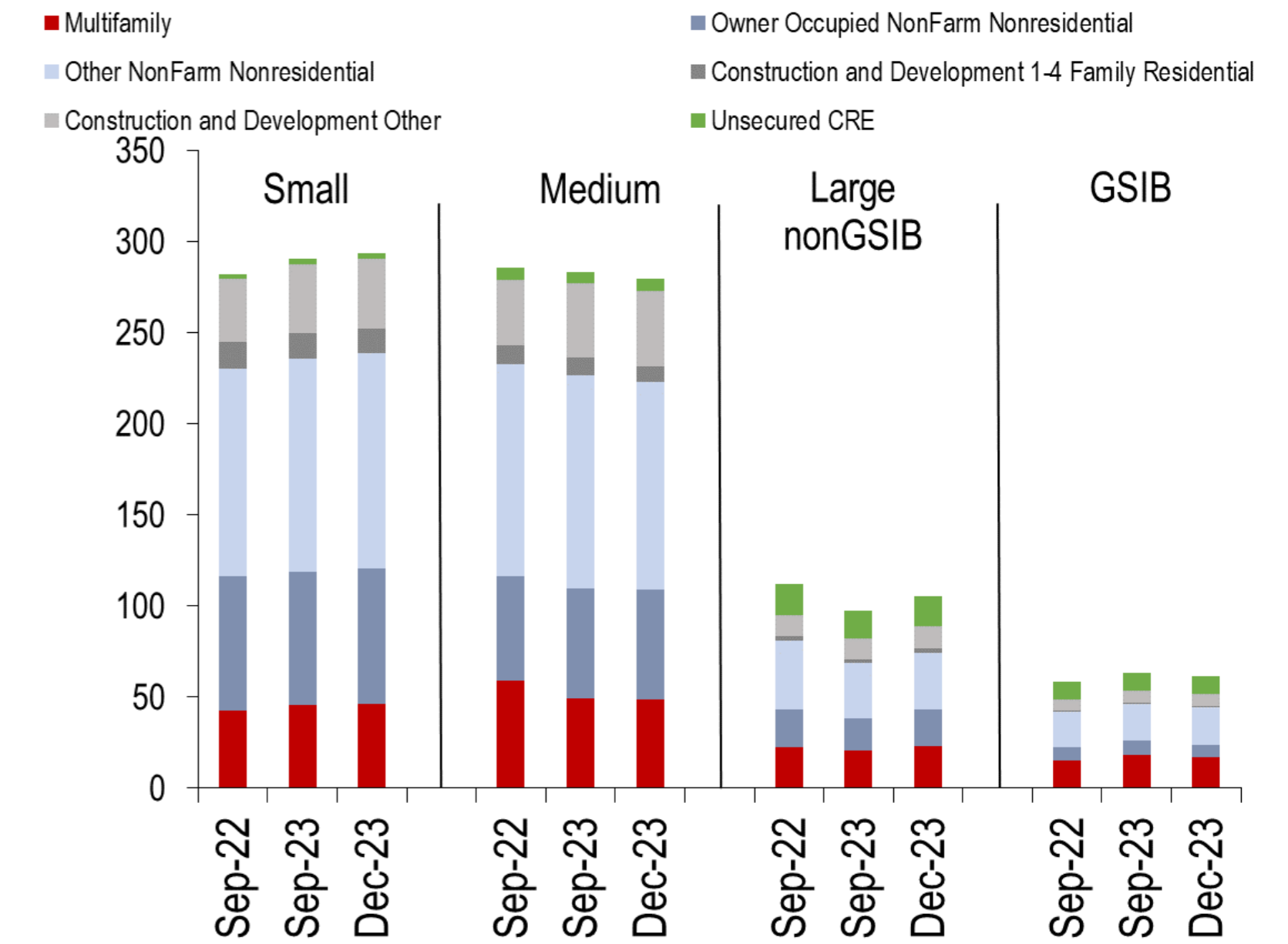
are falling across most banks in the United States subcomponent of CRE across banks in the United States.

CRE Coverage and NPL Ratios
(Percent)



Nonfarm nonresidential loans, which includes office, represent the largest subcomponent of CRE across banks in the United States.

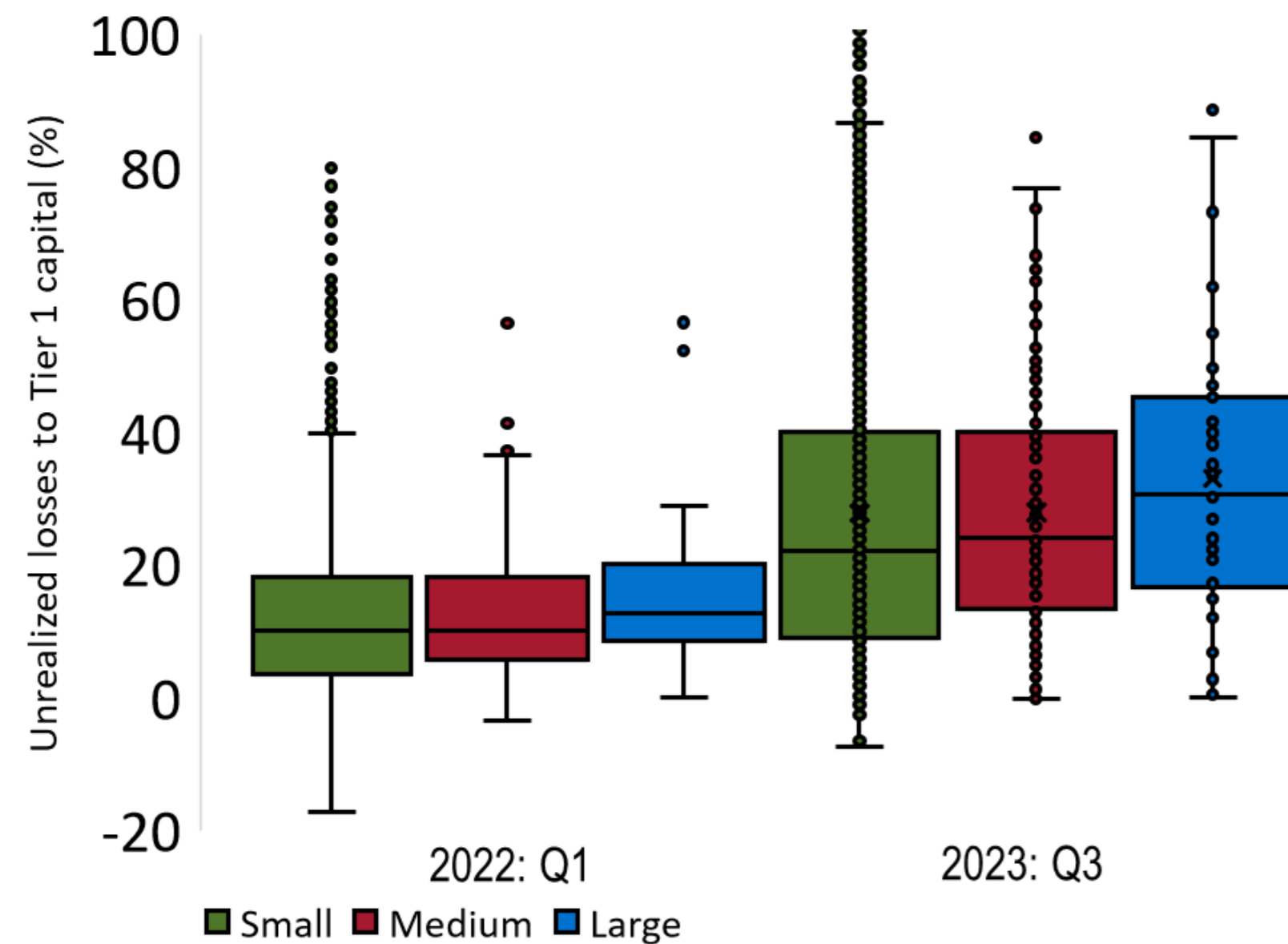
CRE Segment Exposure to Tier 1 Capital
(Percent)



Regionals Banks Are Not Out of the Woods

Unrealized losses increased as interest rates climbed.

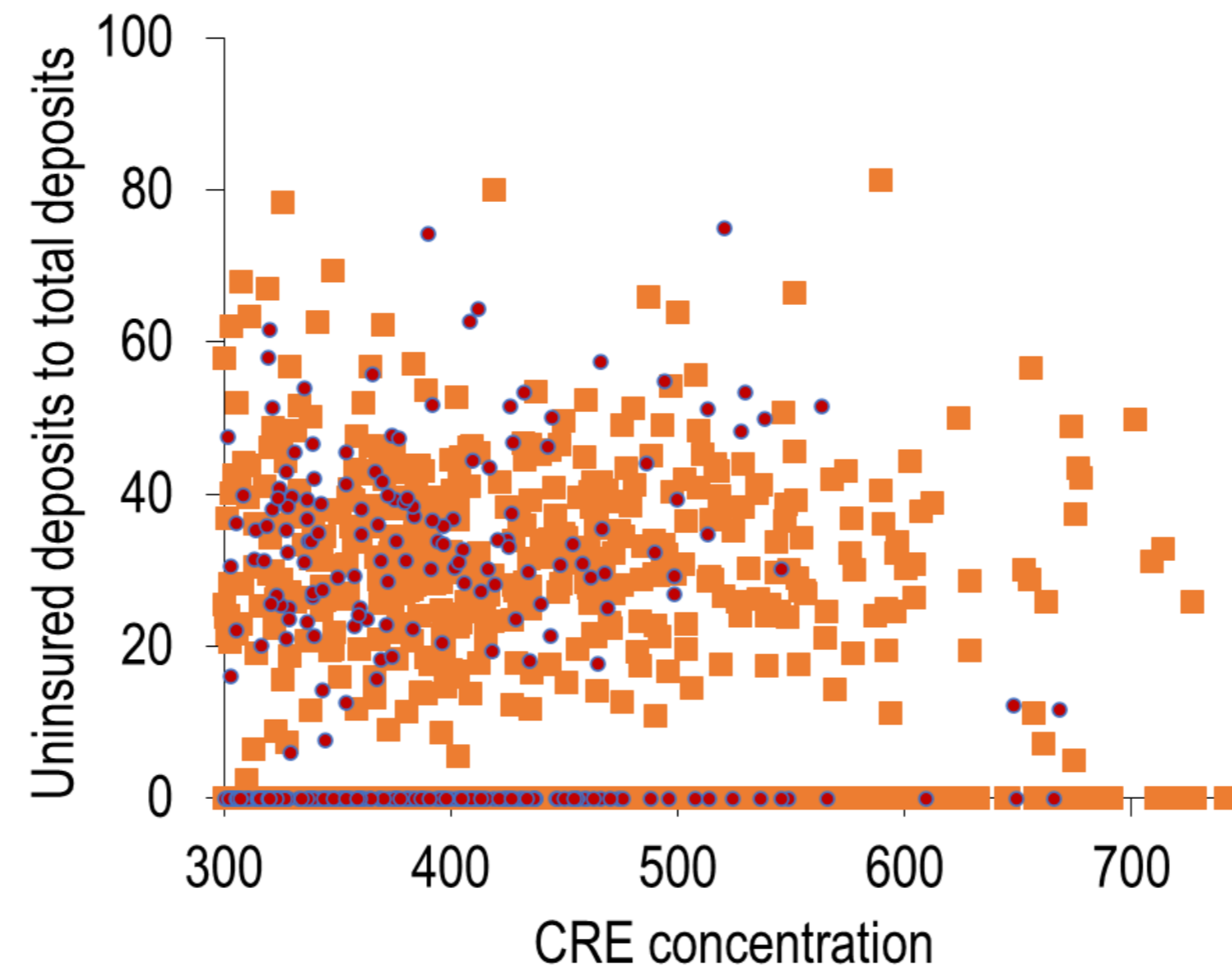
Unrealized Losses to Tier 1 Capital (Percent)



A significant number of US banks have high CRE concentration, high share of uninsured deposits, and large unrealized losses.

Banks with High CRE, Uninsured Deposits and Unrealized Losses

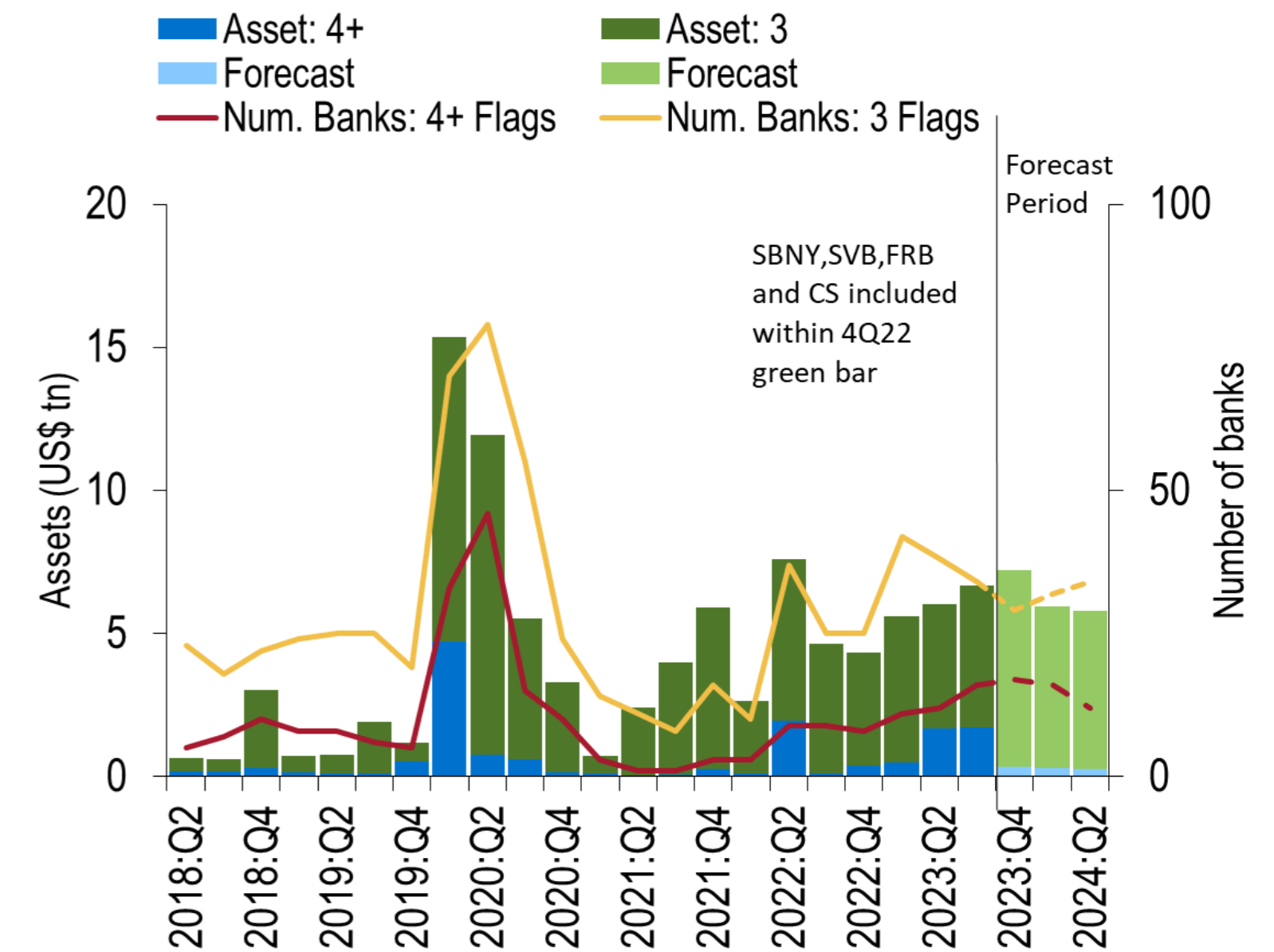
(Red dots correspond to banks with unrealized losses > 25 percent of Tier 1 capital)



The weak tail of banks remains elevated in the first half of 2024.

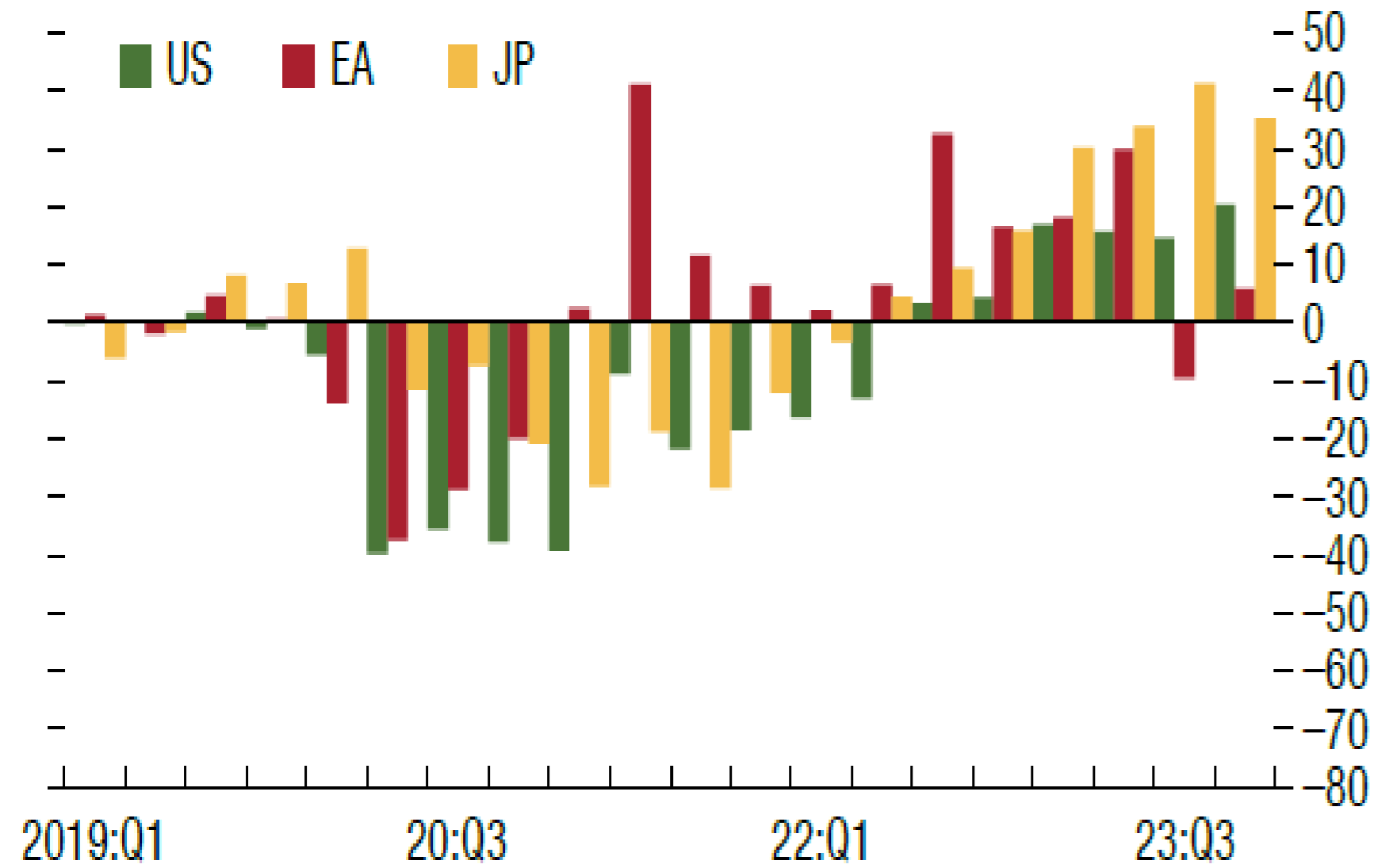
Banks Flagged in a Majority of Risk Indicator Dimensions

(Total assets, trillions of US dollars, left scale; number of banks, right scale)

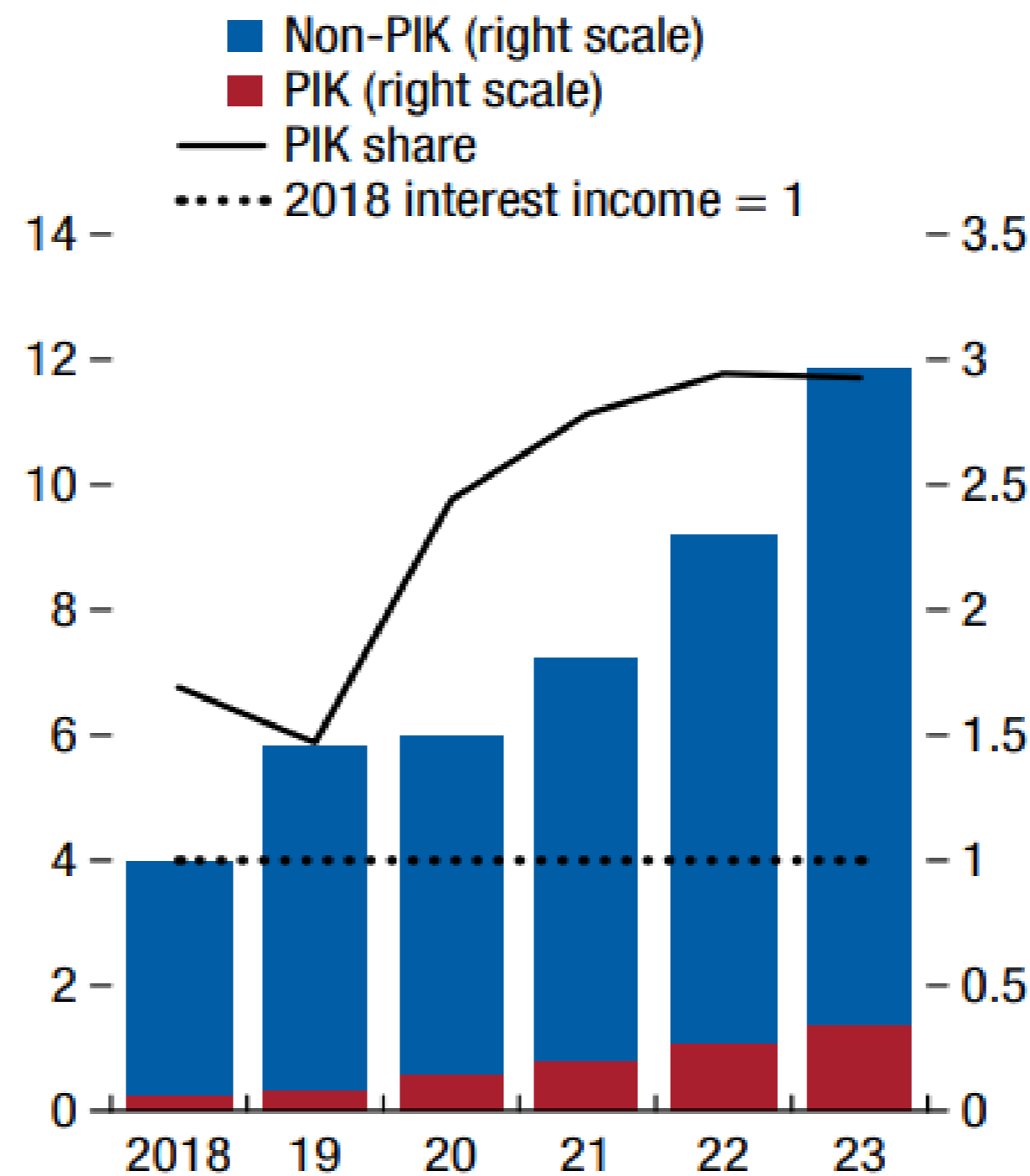


Credit Cycle Downturn Could Intensify

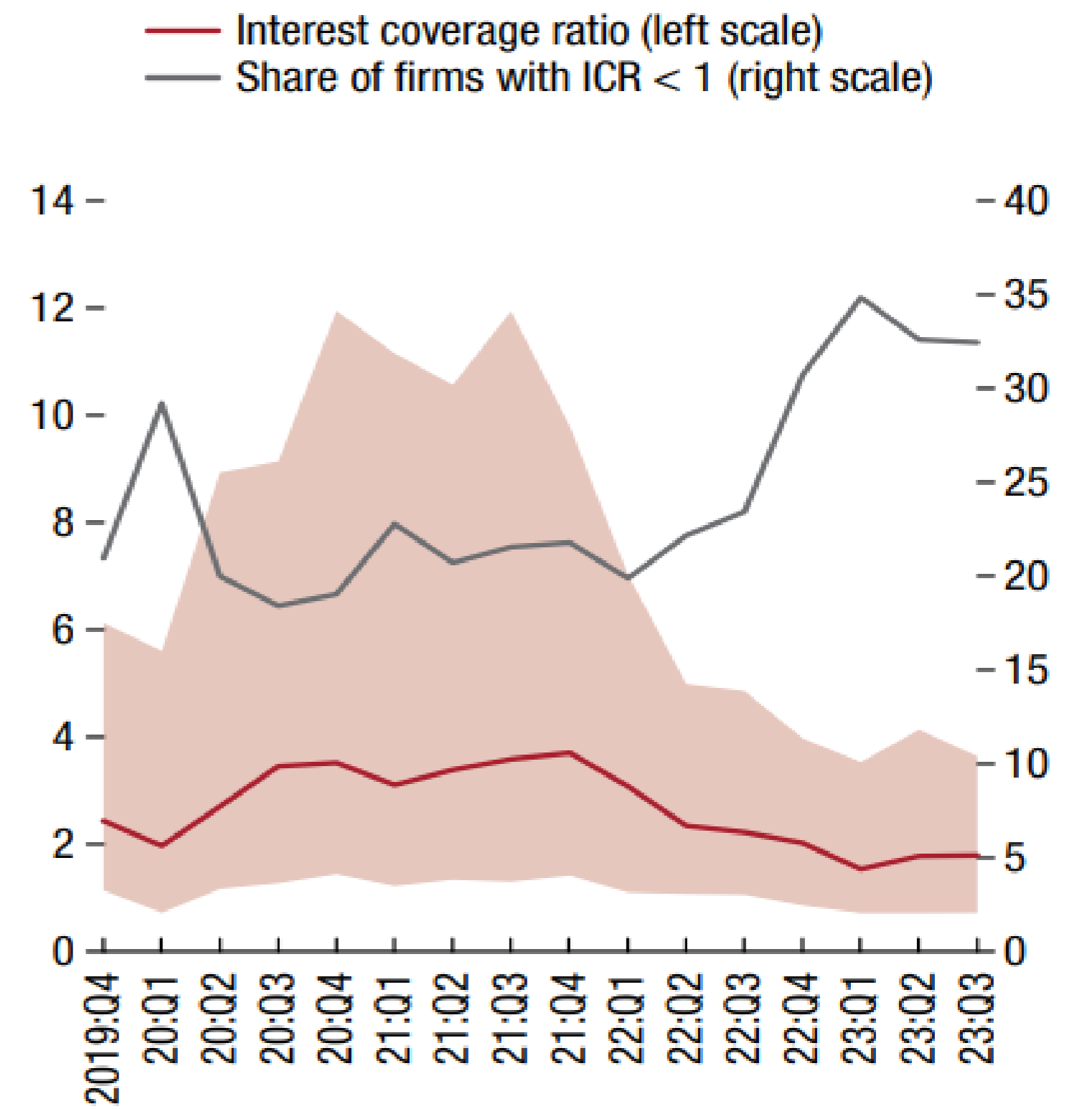
Corporate Bankruptcy Year-on-Year Rate
(Percent)



Payment-in-Kind Share of Business Development Companies' Income
(Left: Percent; Right: Index w/ 2018=1)



Interest Coverage Ratios of Middle Market Companies
(Percent)



Source: Bloomberg L.P., Dealogic, Haver Analytics, IMF staff calculations.

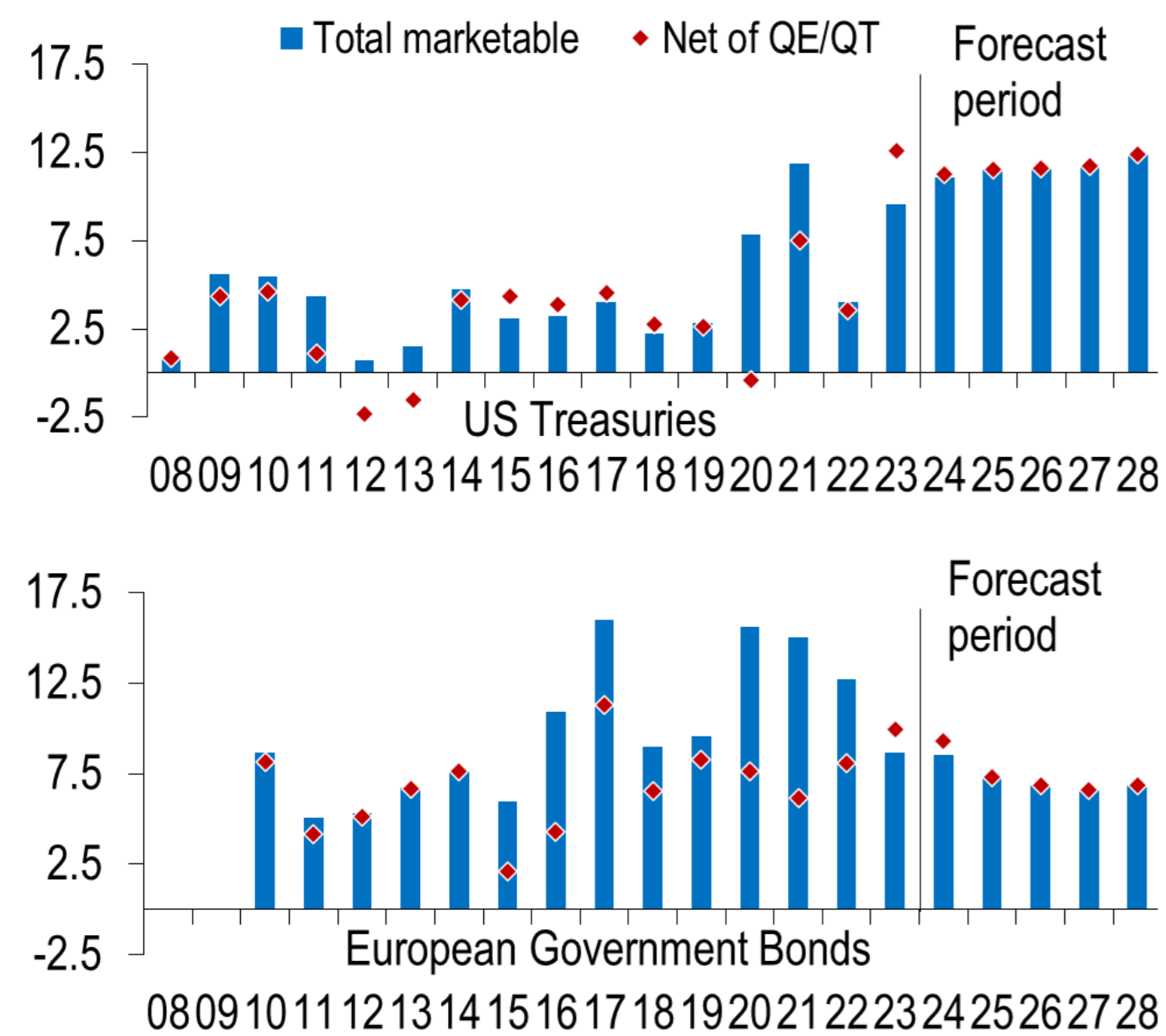
Government Debt Becoming a Focal Point

Net supply of advanced economy bonds .. with some evidence that sensitivity of yields to auction demand has increased ...

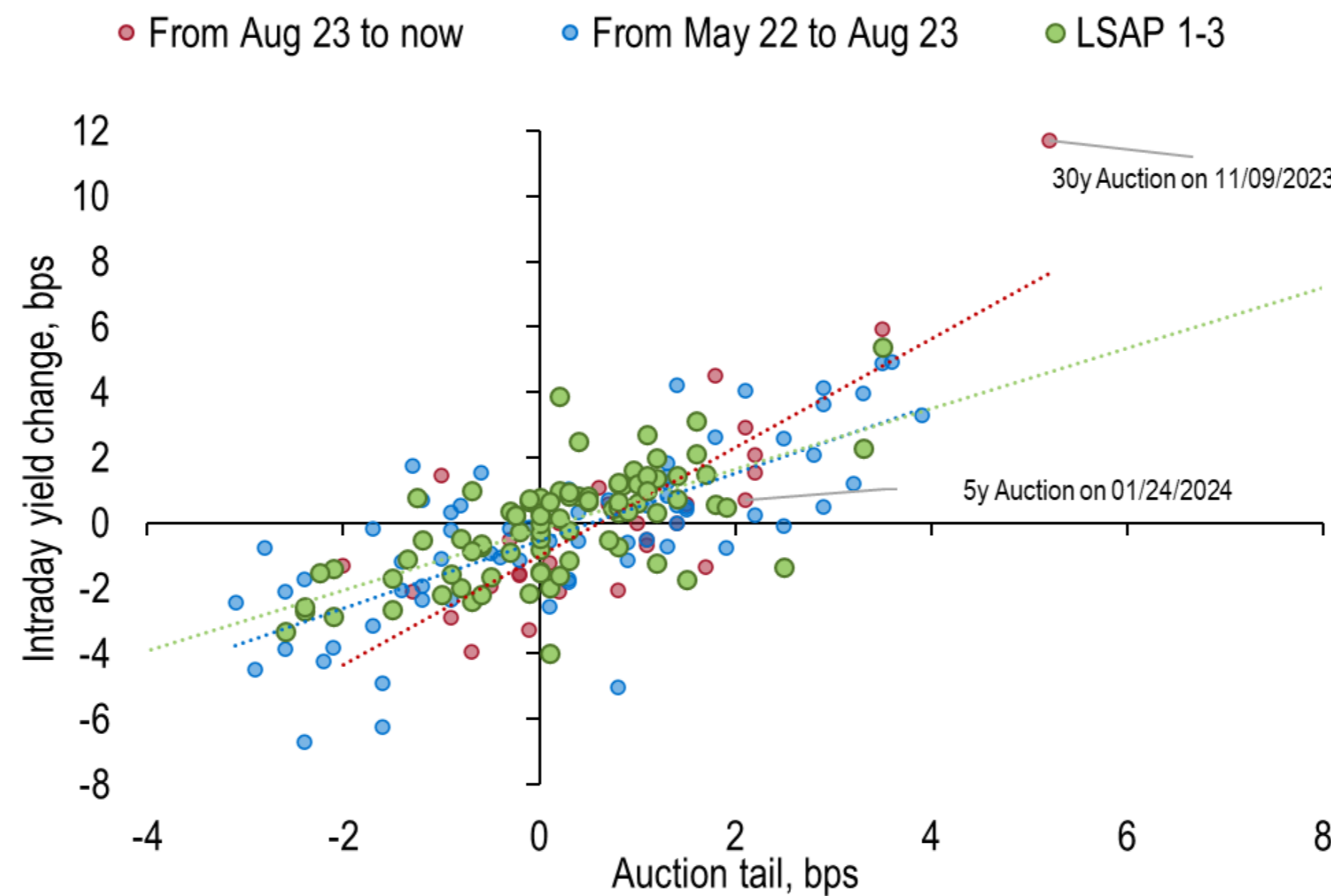
Upward pressure on real term premiums could persist as share of Treasury securities outstanding (net of Fed holding) continues to rise.

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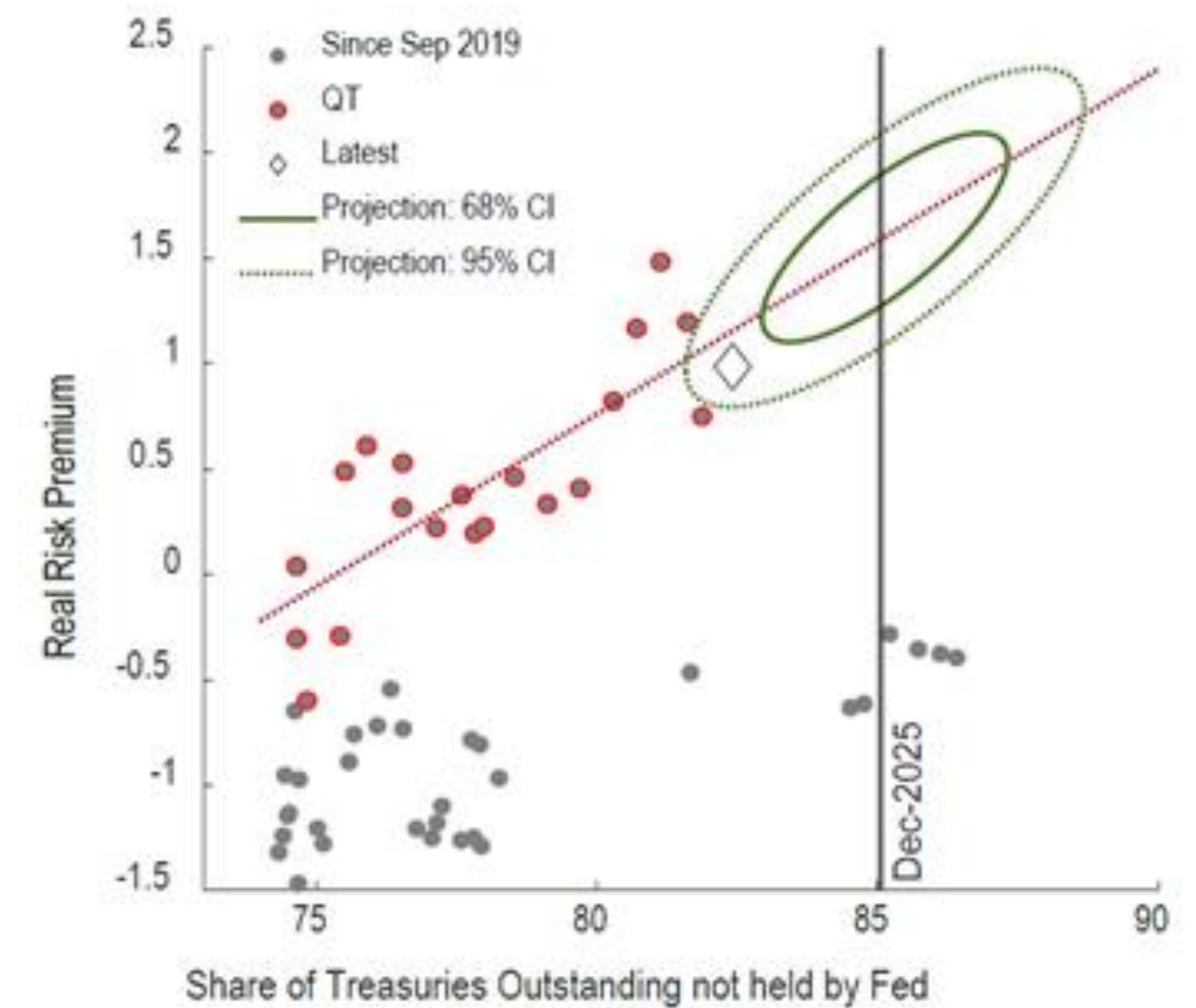
Net US and EU Treasury Duration Supply Relative to GDP (Percent)



Sensitivity of Treasury Yields to Auction Demand (Basis points)



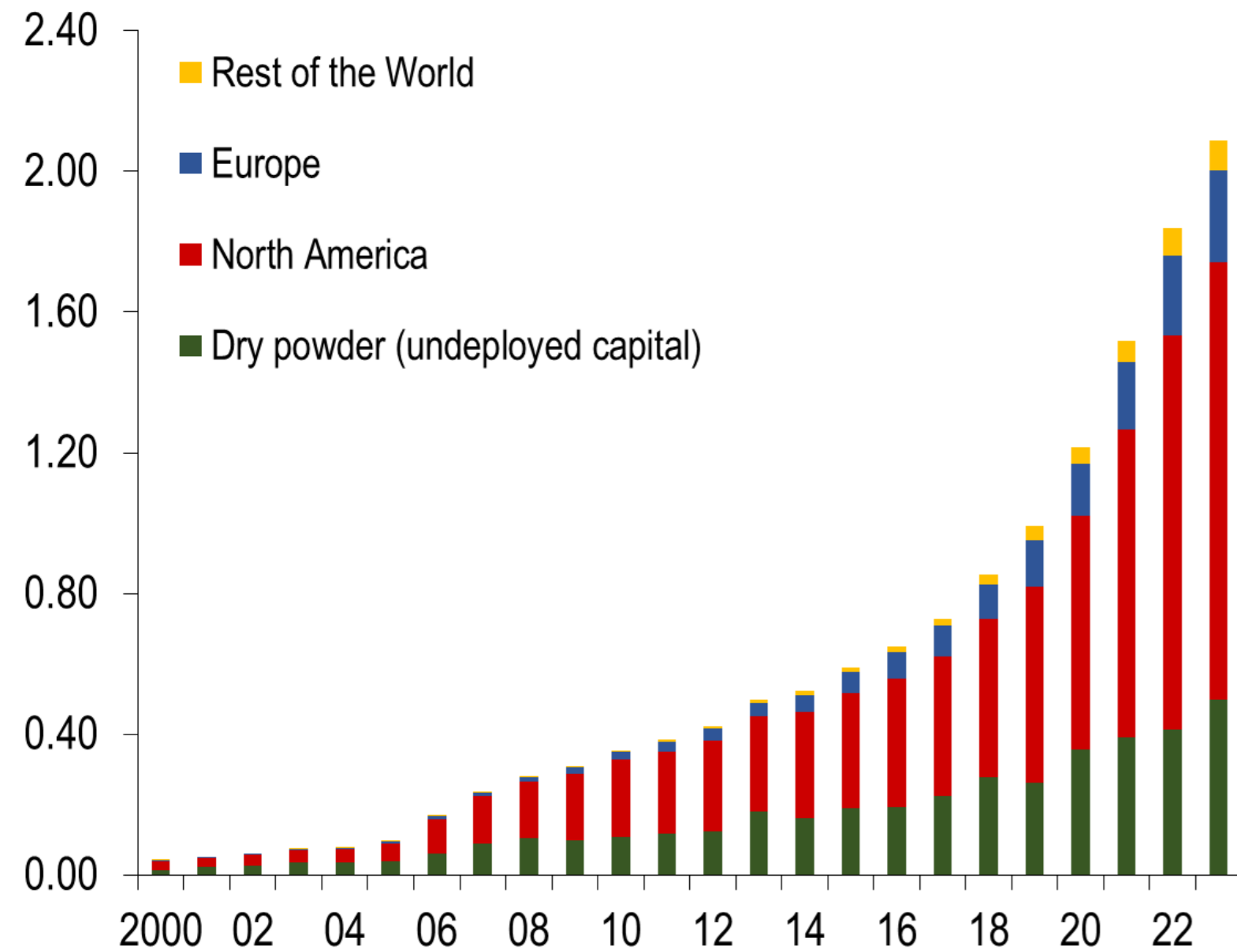
Projected US 10-Year Real Term Premiums Based on Forecasted Treasury Securities Outstanding (Percent)



Private Credit Growth and Mounting Vulnerabilities

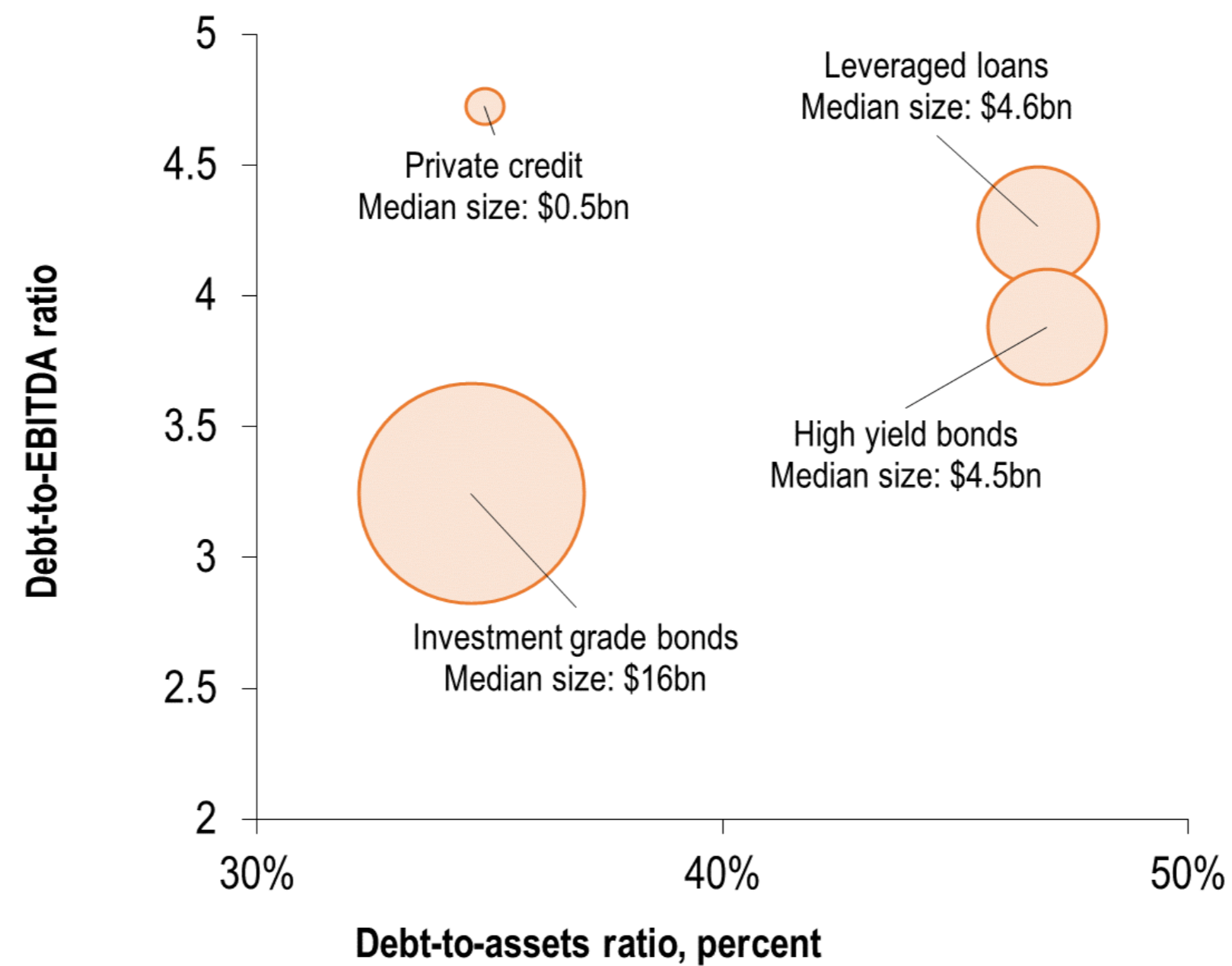
Exponential growth over the last two decades

Private Credit Growth
(USD, trillions)



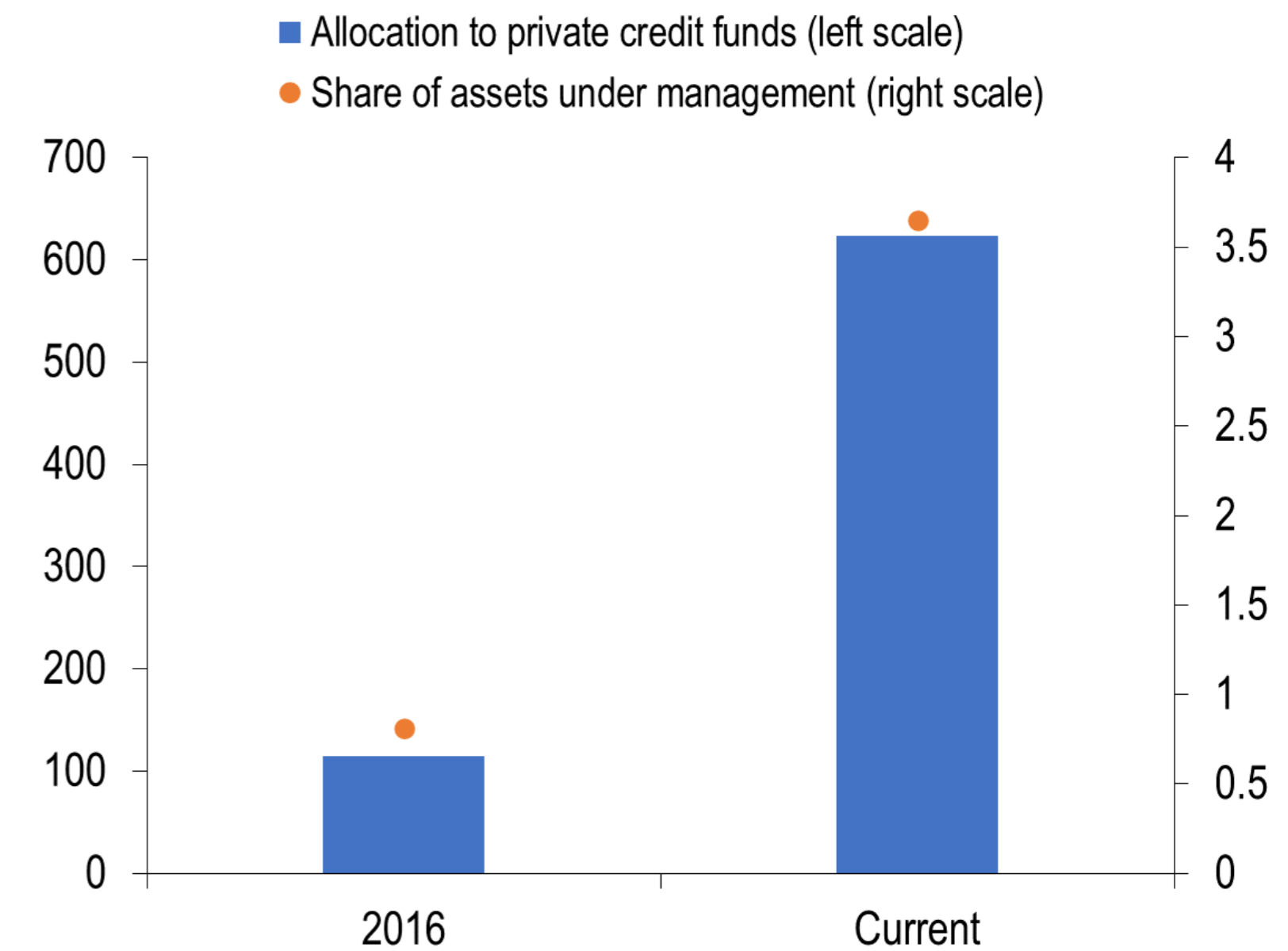
Borrowers are smaller and more leveraged

Leverage by Issuer Type
(Percent)



Rapid increase in exposures of traditional financial institutions

Investment in Private Credit Funds by Pension Funds and Insurance Firms
(Billions of US dollars; percent)



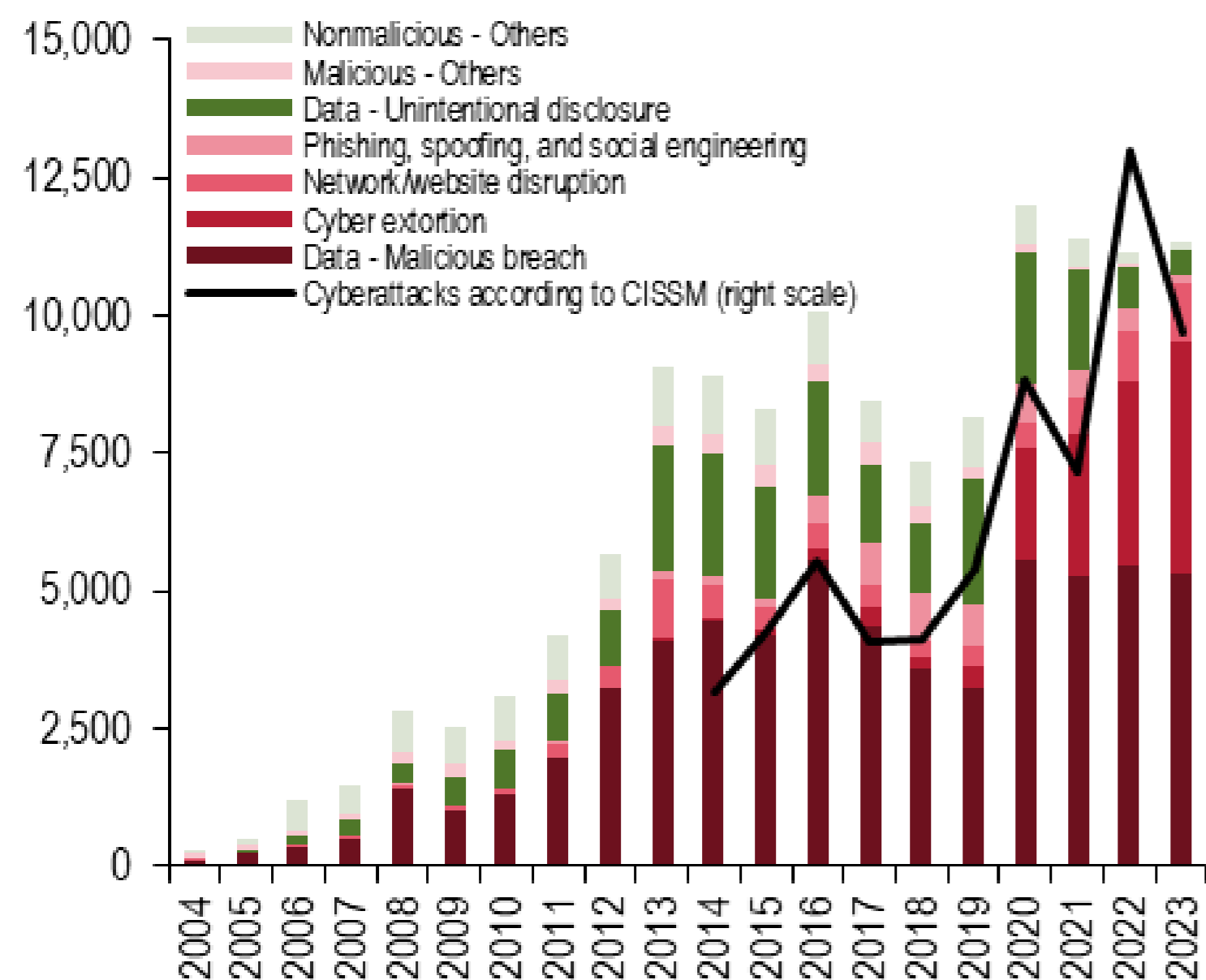
Cyber Risks are a Growing Concern for Macrofinancial Stability

The number of cyber incidents, and especially cyberattacks, has risen sharply

Financial institutions are notably exposed, with about one-fifth of incidents occurring in the financial sector

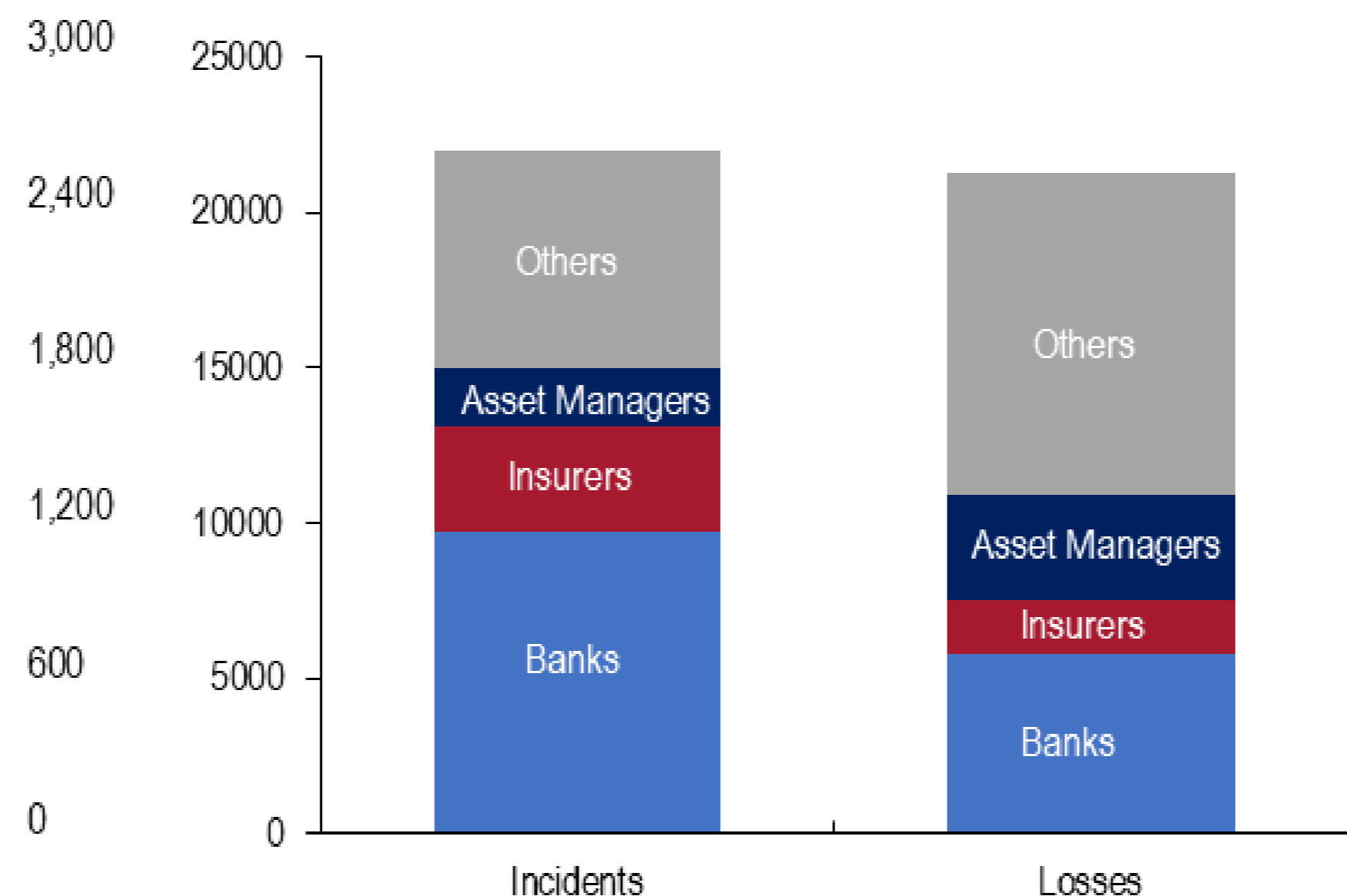
The risk of extreme losses due to cyber incidents has been increasing

Global Number of Cyber Incidents (Number)



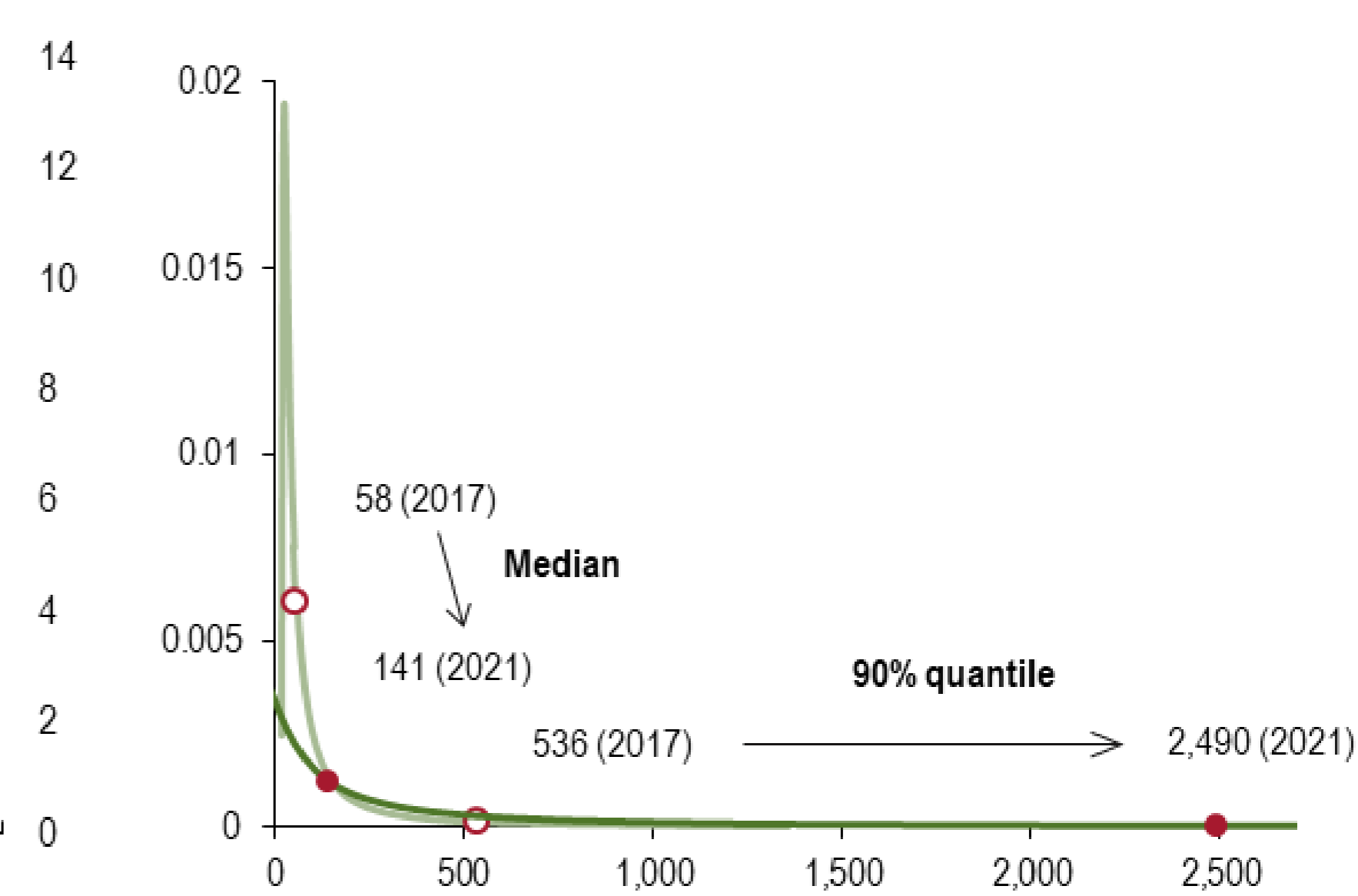
Cyber Incidents and losses in the Financial Sector, 2004-2023

(Number, left scale; billion US dollars, right scale)



Estimated Distribution of Maximum Annual Firm Loss (Density; millions of dollars)

(Density; millions of dollars)



Global Financial Stability Report

